SPECIAL ISSUES OF ACCOUNTING FOR CHARITIES IN NEW ZEALAND

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ABSTRACT

The role of the nonprofit sector is increasing because of 'new public management'. Calls for improvements in the accountability of nonprofit organizations led to the sector's inclusion in the FASB's conceptual framework developed in the United States and, consequently, in other conceptual frameworks including New Zealand's, as they have relied on the FASB's model. Application of the conceptual framework to the nonprofit sector has been criticized and claims made that it should not be applied to charities. This research focuses on charities in New Zealand to determine whether there are special issues relating to them. It involves a survey of thirty five charities using a pattern matching approach to determine whether patterns observed overseas match those to be found in New Zealand. Two of the conclusions drawn are likely to apply to all charities. The economic focus of the conceptual framework has not been defined but charities commonly have non-economic objectives and take part in transactions that may not be economic events. Charities rely on receiving resources from lay users of financial reports. The definitions adopted in the conceptual framework together with insistence on 'conceptually pure' financial statements requiring a focus on change in net assets is likely to result in misunderstanding of those financial reports. Consequently such financial reports will not be decision useful. Two other conclusions apply specifically to charities in New Zealand. Supervision of charities and their fundraising practices is lacking and, despite the increased role of the nonprofit sector and dependence on it, opportunities for abuse have the potential to damage the fundraising abilities of genuine charities. The conceptual framework's applications to the nonprofit sector requires an understanding of the sector's fund accounting roots. The development of decision useful standards requires recognition of the place of fund accounting and development of authoritative support for acceptable fund accounting practices.

CHAPTER 1

INTRODUCTION

Charities are:

> A broad group of organizations that have paid employees and volunteers and that are entitled to a number of fiscal concessions and support from public funds. These organizations exist independently of the state, engage in activities of some common concern of members, but which benefit persons beyond their own membership and which are formally controlled by an unpaid board of trustees. (Saxon-Harrold, 1990, p124)

A charity has a public purpose and those purposes were defined in Pemsel's Case to fall within four classes (Brown, 1975, p42):

- the relief of poverty;
- the advancement of education;
- the advancement of religion; and
- for other purposes beneficial to the community not falling under any of the preceding heads.

One of the distinctive features of a charity is that it will obtain resources from people or organizations who may receive no financial benefit in return and apply those resources for the charitable purpose.

Charities form a part of the nonprofit[1] sector of the economy and references to that sector and nonprofit organizations may be read as including charities. In the

[1] Although "nonprofit" is a commonly used term, it is a misnomer as there is no bar to the organizations in this sector earning a profit. Instead, unlike business organizations, they have no owners with rights to any distribution of surpluses generated (James & Rose-Ackerman, 1986, p2) and such surpluses are considered to be distributed among consumers (Ben-Ner, 1986).

United States the Commission for Private Philanthropy and Public Needs considered the nonprofit sector important, observing its flexibility and ability to support causes normally ignored under majority rule. The sector was also credited with improving the level of social integration and testing innovations later adopted by government and business (Smith, 1983).

1.1 ATTENTION TO THE NONPROFIT SECTOR

Interest in the nonprofit sector has increased since 1975 when the Commission for Private Philanthropy and Public Needs released its findings. Relevant to this research are two of those findings:

- that government could reduce its activities by funding, but not necessarily providing welfare services; and
- that the financial reporting of nonprofit organizations was unsatisfactory and required attention.

Since that time there has been considerable research into the nonprofit sector. The economic and social roles of the sector have been examined and public policy developed. It was included in the Financial Accounting Standards Board's conceptual framework project which was initially for the business sector only, and accounting standards for application to the nonprofit sector are being developed.

In New Zealand the nonprofit sector appears to have escaped much of this attention although public policy which would devolve responsibilities from the government to the nonprofit sector has been developing since 1984 when the Labour government was elected and the 'new public management' approach of Rogernomics was adopted. After a controversial proposal to tax charities and remove donor tax exemptions was deferred in 1988 a working party was established with a brief, *inter alia*, to define a role for a Charity Commission.

The report of that working party appears to have been shelved and in New Zealand the role of the nonprofit sector has increased but there has been little or no attention paid to the accountability and financial reporting of the sector. Such attention comes by default from the United States as New Zealand's conceptual framework, adopted in June 1993, draws heavily on the Australian one (Mackenzie, 1993) which is in turn described as an "outgrowth and development" (Hodgson, Holmes & Kam, 1992, p420) of that developed by the FASB. It has implications for major changes in the financial reporting of nonprofit organizations in New Zealand.

The inclusion of the nonprofit sector in the FASB's conceptual framework has been controversial with the greatest concern expressed about those nonprofit organizations that "offer collective goods with funds provided in fixed amounts by granting agencies" (Beechy & Zimmerman, 1992, p483), or are "predominantly financed by 'non-reciprocal transfers' such as grants, contributions and taxes" (Anthony, 1978, p9). Typical of such organizations are charities and it is for this reason that this research focuses only on charities although the conceptual framework and standards apply to all of the nonprofit sector.

1.2 RESEARCH OUTLINE

The next chapter provides insights on the role of the nonprofit sector, outlining reasons for its existence, characteristics of nonprofit organizations and the development and effects of 'new public management'.

Chapter 3 backgrounds the problems with accounting standard setting in the 1960s and the views leading to the decision to develop a conceptual framework. It also considers the concerns raised over financial reporting in the nonprofit sector and events leading to the FASB's decision to include the nonprofit sector in its conceptual framework. Assessments of the conceptual framework and views on its usefulness for accounting standard setting are examined before considering the implications of the conceptual framework for financial reporting in the nonprofit sector.

Chapter 4 considers the regulation of financial reporting of charities including accounting standards, the audit of financial reports, externally imposed regulations by government bodies and self-regulatory practices. Chapter 5 examines the economic and social factors affecting charities in New Zealand as well as the regulation of financial reporting.

Chapter 6 explains the methodology adopted in this research followed by chapters 7 and 8 which examine the financial reports and constitutions of charities taking part in this research. Chapters 9, 10 and 11 consider the perspectives of auditors, the charities and funding bodies.

Finally chapter 12 presents a summary, limitations, conclusion and directions for future research.

1.3 BENEFITS OF THE STUDY

There has been little research into the financial reporting of charities in New Zealand yet these organizations are included in New Zealand's conceptual framework and in the accounting standards set by the New Zealand Society of Accountants. Beneficiaries of this research will be all those involved in the charitable sector including the charities themselves, funding agencies, auditors and accounting standard setters. In addition, those developing public policy may find some aspects of this research useful.

In particular, however, the research is directed towards the accounting profession to:

1. consider the effects shortcomings of the conceptual framework will have on accounting for charities in New Zealand;
2. increase understanding of the charitable sector and enhance the decision usefulness of financial reports of charities by promulgating appropriate accounting standards;
3. remedy the lack of authoritative pronouncements in respect of the nonprofit sector including audit guidance and acceptable fund accounting practices and to clarify the application of accounting standards.

CHAPTER 2

ROLE OF THE NONPROFIT SECTOR

2.1 INTRODUCTION

Government and nonprofit organizations were commonly thought to compete with each other but, in both the United States and the United Kingdom, the development of the welfare state brought increases in the activities of nonprofit organizations (Saxon-Harrold, 1990; Salamon, 1990). The reason for this is that, although the state undertook a number of responsibilities for welfare provision, in many cases it merely funded services without actually providing them, and those services tended to be carried out by nonprofit organizations[1]. The existence of this partnership between nonprofit organizations and the government was not commonly noted (Salamon, 1990). It is referred to in the United States as third party government, and this is thought to be an accurate description of the state of affairs that existed in the past and is developing further today (Salamon, 1990).

This chapter considers reasons for the existence of the nonprofit sector, including reasons why nonprofit organizations may be considered acceptable providers of welfare services and outlines characteristics of nonprofit organizations.

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[1] In the United States this method of operation is considered to provide a resolution to conflict between the desire for public services and hostility towards any government body that provides them (Salamon, 1990).

The Commission for Private Philanthropy and Public Needs directed attention to the nonprofit sector in the United States. This was in 1975 at a time of economic difficulties when the role of government was being questioned. Since then there has been an international trend for governments to increase the extent to which welfare service provision is delegated and nonprofit organizations have undertaken some of this work. In many cases this delegation has resulted in some loss of control over those services. Offsetting this loss of control are accountability requirements for both the funds handled and the services provided.

2.2 REASONS FOR EXISTENCE OF NONPROFIT SECTOR

Economists have proposed reasons why the nonprofit sector exists, defining the sector as occupying the area where both market failure and government failure occur (James & Rose-Ackerman, 1986). Their reasoning has been criticized for:

- including an assumption of a free-market process even though imperfect competition exists; and
- overlooking the fact that recipients of services provided may have no choice over the type of institution providing the services. The choice of institution is made by the funders (Badelt, 1990).

However, economists maintain that in some situations nonprofit organizations have an advantage over both for-profit firms and government organizations (Anheier & Seibel, 1990), providing "an alternative to the disadvantages associated with both profit maximization and bureaucracy by combining the flexibility and efficiency of the market with the equity and predictability of public bureaucracy" (Seibel & Anheier, 1990).

2.3.1 Government Failure

The services provided by government tend to be rigidly defined and designed to cater to a wide ranging but unspecialized clientele. Dissatisfaction with the amount or diversity of these services tends to result in alternatives being sought, and it is common for a nonprofit organization to provide those alternatives (James & Rose-Ackerman, 1986). Reasons for this are that the nonprofit organization can experiment, undertake activities that may take some years before benefits are achieved or be more flexible to changing demands (Knapp, Robertson & Thomason, 1990). Services may also be provided less expensively, or may be provided only by a nonprofit organization (James & Rose-Ackerman, 1986) .

2.3.2 Market Failure

Nonprofit organizations are commonly considered more trustworthy than business organizations and their non-distribution constraint is considered to aid in this perception (James & Ackerman, 1986). Economists using principal-agent theory have observed that where information asymmetry occurs or where the output is unobservable nonprofit organizations are considered less likely than business organizations to reduce the quality of services (James & Rose-Ackerman, 1986). It has also been noted that it is not merely the non-distribution constraint which is perceived to reduce the market failure problem. Where religious[2] organizations provide such services they are considered more trustworthy than others (James & Rose-Ackerman, 1986).

2.3.3 Consumer Control and Participation

In some instances consumers may wish to have control over and participate in the services produced. This is likely to occur when business organizations would have the opportunity and incentive to cheat consumers (Ben-Ner, 1986) and where

[2]Prior to government involvement religious organizations played a major part in welfare provision and many nonprofit organizations, especially those in health and education, were founded by religious groups (James & Rose-Ackerman, 1986). An important feature of these organizations is that the founders are not motivated purely by money, but also have strongly held beliefs. The object of such organizations is not to maximize profits, but to spread their beliefs and to increase the number of followers of those beliefs (James & Rose-Ackerman, 1986).

there is concern for quality of service. Providing voluntary labour, which commonly occurs in nonprofit organizations, enables a form of consumer control to be exercised in that the donor of the labour is able to monitor the quality of the services provided (James & Rose-Ackerman, 1986).

2.3 CHARACTERISTICS OF NONPROFIT ORGANIZATIONS

Salamon (1990) observed that although the nonprofit sector may compensate for government and market failure it also has limitations. He identified these limitations referring to them as voluntary failure (Salamon, 1990, p230):

- philanthropic insufficiency: voluntary contributions are not necessarily available where the greatest needs occur;
- philanthropic particularism: a focus on particular problems leading either to other problems not being addressed or to the duplication of services;
- philanthropic paternalism: assistance from voluntary organizations is not received as of right; and
- philanthropic amateurism: the services provided may not reach professional levels because of possible instability and unevenness in provision.

Some of the reasons for voluntary failure may be deduced from the characteristics of voluntary nonprofit organizations (Kramer, 1990, p261):

- Income is derived from many sources and related to fundraising ability rather than to performance;
- The recipients of services provided have less influence on those services than do those leading the organization;
- Influences on the organizations include values and ideologies as well as public policy;
- Formal and informal power structures arise from mixtures of both paid and voluntary staff;
- Power struggles can occur between voluntary and paid staff;
- Vulnerabilities include the possibility of institutionalization, goal deflection, minority rule, and ineffectuality.

An example of voluntary failure may be seen where one area of interest is relatively well provided for while another area which is perhaps less appealing is neglected.

2.4 RISE IN INTEREST IN NONPROFIT SECTOR

In 1975, after years of being ignored in political debate (Salamon, 1990), attention was drawn to the nonprofit sector in the United States by the report of the Commission for Private Philanthropy and Public Needs (Seibel & Anheier, 1990). This discovery of the nonprofit sector occurred at a time when attempts were being made to reduce the responsibilities of government and, at the same time, national and international economic difficulties were being encountered (Seibel & Anheier, 1990).

A level of agreement developed that the state should withdraw from direct provision of welfare and instead support the nonprofit sector in providing that welfare (Salamon, 1990). Because of hostility towards government provision of such services, proposals such as this tended to receive widespread support (Salamon, 1990).

2.5 GOVERNMENT WITHDRAWAL FROM WELFARE PROVISION

Internationally policies have moved towards the withdrawal of governments from the direct provision of some welfare to a position of funding but not providing that welfare (Fraser & Wilson, 1988; Hood, 1991; Dell, 1992). Several factors have been identified as contributing to these policies including fiscal crises (James, 1990; Broadbent & Guthrie, 1992), increasingly large bureaucracies which are considered a threat (Salamon, 1990; Beilharz, Considine & Watts, 1992) and changes in ideology towards economic rationalism (Broadbent & Guthrie, 1992), which is associated with monetarism (Foster & Kelly, 1992). Hood (1991) called these government policies 'new public management' and considered it to be a blending of two different and possibly conflicting sets of ideas:

- institutional economics which focuses on "contestability, user choice, transparency and close concentration on incentive structures" (Hood, 1991, p5);
- managerialism which focuses on "professional management expertise as portable, paramount over technical expertise, requiring high discretionary power to achieve results and central and indispensable to better organizational performance ... and the active measurement and adjustment of organizational outputs" (Hood, 1991, p6).

The relative strength with which each of these two sets of ideas was adopted varies[3] (Hood, 1991).

This new public management and the tendency to withdraw from direct welfare provision has increased the level of dependence on the nonprofit sector[4] for welfare provision and is seen as a way in which a government can achieve more with the funds it has (James, 1990).

Possible reasons for preferring some contracted services to be provided by nonprofit organizations include a perceived community belief that such organizations will provide a high quality service, and the possibilities of those organizations receiving community support and reaching those interested in the service (Ferris & Graddy, 1986). The main advantage of service contracting, however, is the likelihood of achieving cost savings (Ferris & Graddy, 1986). The reasons that provision of welfare services through the nonprofit sector, as opposed

[3] In the United Kingdom and Australia the managerialism aspect is considered dominant (Hood, 1991).

[4] In the United Kingdom this has been referred to as remixing the economy, and the importation of terms, such as service contracting, from the United States has been observed (Knapp, Robertson & Thomason, 1990).

to the business sector, may be considered cheaper include (James & Rose-Ackerman, 1986, p30):

- the monitoring of services may be costly and it may be perceived that less monitoring would be required;
- nonprofit organizations tend to pay lower wages;
- volunteer support is most commonly provided to the nonprofit sector and means that services over and above those paid for may be able to be provided;
- it may be more acceptable for fees to be charged by nonprofit organizations than by government bodies;
- the services may be able to be subsidized from other sources of funds so that full costs are not met by government (Ferris & Graddy, 1986).

Nonprofit organizations commonly conduct some activities in order to subsidize others (James, 1983). In both the United States and the United Kingdom some of the government withdrawal from welfare service provision was accompanied by verbal but not financial encouragement to the nonprofit sector to provide welfare services. Government funding of the nonprofit sector was also reduced, forcing those in the sector either to find other sources of funds to supplement the costs of the increasing demands for their activities or to reduce their activities (Hammonds, 1990; Salamon, 1990; Knapp, Robertson, & Thomason, 1990; Saxon-Harrold, 1990). In seeking other sources of funds, nonprofit organizations increased both their commercial activities and requests to corporations for funding (Schlossberg, 1989). There was an expectation that the private sector would "take up the slack" following government cutbacks (Schlossberg, 1989; Zetlin, 1990), but there were warnings in Australia that economic conditions meant increased corporate support could not be expected (Cohn, 1992). The increases in commercial activities have led to a debate that the nonprofit sector is engaging in unfair competition with the business sector (Simon, 1990).

James (1983) warned that reducing government support of nonprofit organizations while at the same time increasing public need for their services could lead to such increased efforts in profit-making activities that the character of those organizations would be changed.

2.6 INCREASE IN ACCOUNTABILITY REQUIREMENTS

Although there had for some time been a close relationship between government and nonprofit organizations, this relationship was recognized only relatively recently (Salamon, 1990). The contracting out of welfare provision is considered to enable separation of the funder from the provider of those services. In many cases this involves the formalization by contract of a situation that already existed (Lewis, 1993). Hood (1992) likened the change in service provision arrangements to moving from a high-trust contracting environment where there is some commitment to a long-term relationship to a low-trust environment where there is a much shorter term focus with detailed specification of the arrangements made.

Although a major advantage of contracting out the provision of welfare services is the potential cost savings, in achieving such savings there is a loss of control over delivery of the service and this threatens (Ferris & Graddy, 1986, p333):

- the continuity of service delivery;
- the service quality; and
- the ability to achieve the objectives of distributing the service .

The acceptability of some loss of control, and therefore a decision whether to contract out the provision of services, depends on both the financial state of a government and the level of political pressure it is subjected to; however, contract clarity and performance monitoring are expected to achieve a reduction in that loss (Ferris & Graddy, 1986).

Government imposition of increased accountability requirements for the funds handled and for the services provided has accompanied the change to formal contracting (Leat, 1990). Such requirements are a part of the new public management approach (Hood, 1991) calling for a focus on "cost, efficiency, outputs and performance accountability" (Broadbent & Guthrie, 1992, p3).

Concern has been expressed by nonprofit organizations at government accountability requirements (Salamon, 1990). These requirements involve administration costs of obtaining, receiving and reporting on the public support but generally there is no ability to recover these costs[5] (Knapp, Robertson & Thomason, 1990). James (1990) outlined some of the accountability requirements and methods of monitoring, noting that in many cases controls are exercised over inputs used, the criteria for selecting those who receive the services and the price that may be charged. These controls are imposed on the basis that, as the government is providing the funds, it should also be able to exercise influence over the services provided. A warning has been issued that if the constraints imposed are too great and the values of those in nonprofit organizations not respected, involvement in the contracting out of welfare services may be refused (Rose-Ackerman, 1990). James, however, considered that such regulations would cause nonprofit organizations to become "a public-private hybrid" and may lead to nonprofit organizations becoming indistinguishable from government (James, 1990).

In addition to particular accountability requirements to government as a result of contracting out the provision of welfare services there have been calls for an improvement in general accountability of nonprofit organizations (Gross, 1975; Leat, 1990). In the United Kingdom "the almost non-existent monitoring of charities by central government" (Knapp, Robertson & Thomason, 1990, p183)

[5]When funding is derived from more than one agency the costs incurred are expected to be considerably greater (Knapp, Robertson & Thomason, 1990).

was criticized with calls made for an increase in accountability considered likely to become more urgent as the role of the nonprofit sector expands (Leat, 1990).

2.7 SUMMARY

The existence of the nonprofit sector has been attributed by economists to:

- government failure: the services provided by the government may not be adequate or meet particular needs;
- market failure: where the output is unobservable or where there is information asymmetry a nonprofit organization may be considered less likely than a business organization to reduce the quality of services; and
- consumer control and participation: providing voluntary services to a nonprofit organization allows for monitoring the quality of the services it provides.

Some of the assumptions underlying this reasoning have, however, been criticized.

Voluntary failure has also been observed and this involves focussing on particular problems without addressing others, insufficient contributions to meet needs, amateurism and paternalism.

Nonprofit organizations have been involved in a partnership with government to provide some welfare services although this partnership was not generally recognized. The "discovery" of the nonprofit sector in the United States came at a time of governmental fiscal difficulties when concerns were being raised about the size of government, and hostility expressed toward the government's involvement in the provision of welfare. Since then there has been an international trend towards reducing government provision of welfare and contracting out some welfare services. This is a part of the new public management approach and a greater role for the nonprofit sector has resulted. That role has been accompanied by the imposition of accountability requirements to reduce the loss of control. The extent of these requirements has caused concerns that nonprofit organizations may become indistinguishable from government.

At the same time, however, other reductions in government welfare provision have led to increased demand on the nonprofit sector while government funding of the sector has reduced. This, together with increased demand for services, has led to nonprofit organizations seeking other sources of income by undertaking commercial activities and looking to corporations for funding. The increase in profit making activities has led to concerns being raised that the nonprofit sector is engaging in unfair competition with the business sector and a warning that the extent of increase in profit making activities could alter the character of nonprofit organizations.

In adjusting to meet the increased demands for welfare services nonprofit organizations have had to become more businesslike in seeking additional funding and more bureaucratic to meet the accountability requirements accompanying service contracts. The expansion of the nonprofit sector to meet its increased role has also prompted concerns about the extent to which the sector as a whole is monitored and demands for improvements in general accountability.

CHAPTER 3

CONCEPTUAL FRAMEWORK PROJECTS

3.1 INTRODUCTION

Conceptual frameworks for accounting are a phenomenon of the 1980s. They are currently being developed, or have been developed, in a number of countries including the United States, Canada, Australia, the United Kingdom and New Zealand[1]. The International Accounting Standards Committee has also developed one.

This chapter, using the United States as an example because of the availability of extensive authoritative material, outlines concerns voiced in the late 1960s over the financial reporting of businesses. At the time there was a predominantly descriptive approach to standard setting and a more normative approach was called for. When the Financial Accounting Standards Board (FASB) was formed in 1973 a conceptual framework was on its agenda. In 1976, at the commencement of the conceptual framework project, aspirations were expressed that it would provide an aid to improving standard setting.

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[1] In New Zealand's Statement of Concepts for General Purpose Financial Reporting, when initially published in 1991 as an Exposure Draft, it was stated that the Statement of Concepts was "... not a comprehensive conceptual framework." That caveat does not appear in the revised Statement published in 1993 and one may assume that the Statement of Concepts is a conceptual framework.

Calls were also made to improve financial reporting in the nonprofit sector, and in 1975 the Commission on Private Philanthropy and Public Needs recommended that a single set of accounting principles be developed for nonprofit organizations. In 1978 Anthony conducted a research study for the FASB which later decided to extend its conceptual framework project to include the nonprofit sector. Anthony later resigned from the FASB's nonprofit task force as a result of the conceptual basis chosen for dealing with the peculiarities of the nonprofit sector. This chapter outlines some of his criticisms.

Both the conceptual framework and the extension of it to the nonprofit sector have been controversial. This chapter reviews the assessments of critics and FASB members. Despite criticisms the FASB's conceptual framework has been influential on those being developed in other countries. Conceptual frameworks are being used to assist in developing accounting standards and have implications for major changes to financial reporting in the nonprofit sector. The most significant of these implications are examined.

3.2 CONCERNS OVER FINANCIAL REPORTING

During the 1960s financial reporting came under suspicion because of the choices available which enabled companies to indulge in "... reporting excesses ... [to] ... prop up stock prices, increase borrowing capacity, enhance personal compensation, or maintain or enhance public opinion about managerial skills" (Kirk, 1988, p9). This led to questions over the credibility of the accounting profession and major concerns over the possibility of government intervention in the standard setting process.

3.3 APPROACHES TO STANDARD SETTING

Until the late 1960s a descriptive, or empirical, approach to developing accounting standards tended to be more readily accepted in practice than a normative approach. The descriptive approach, known as the piecemeal approach, was largely based on practice and the standards promulgated were intended to assist the practising accountant (Storey, 1964). It was doubted whether a comprehensive approach to standard setting was feasible and matters requiring attention were dealt with as they arose. There were, however, drawbacks to the descriptive approach (Storey, 1964):

- it resulted in a number of alternative accounting practices and treatments, all of which were condoned by the standards issued[2];
- the resulting standards tended to be shortlived;
- it did not take an overview of the whole discipline of accounting and this caused other problems such as conflict among standards or in other areas as a result of the new standards;
- it assumed that techniques being practiced were right (Tocco & Vierling, 1990, p15).

The concerns expressed about financial reporting in the late 1960s led to increased calls for a normative, or conceptual, approach to standard setting, which reflected the view that developments in accounting should not be so concerned with describing what is, but should instead concentrate on prescribing what should be (Kirk, 1989b; Horngren, 1981). The normative approach moved away from the idea that standard setting should reflect current practice (Tocco & Vierling, 1990). It attempted instead to develop concepts for accounting as a whole and then to apply them by logical deduction to the development of standards (Kirk, 1988). The expectations of this approach were that it would not necessarily solve accounting problems immediately, but it would lead to improvements in standards and practice eventually. A drawback of the normative approach has been that the developments advocated tended not to be adopted in practice (Storey, 1964).

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[2]The APB bulletin on inventory was, "A classic example of trying to please everyone. The committee accepted almost every conceivable inventory valuation procedure" (Storey, 1964, p50).

Although the normative and descriptive approaches to standard setting seem to conflict, Storey (1964) compared them to travelling by different routes to the same destination. He maintained that progress in the development of accounting principles was being delayed because of views that the two methods were opposed to each other. He considered that they complemented each other, and called for a combination of the two approaches.

3.4 CONCEPTUAL FRAMEWORK PROJECT

When the FASB was established in 1973, one of the items on its first technical agenda was the development of a conceptual framework (Sprouse, 1988) which was seen as a normative answer to the perceived problems in accounting.

The FASB defined a conceptual framework as:

> ... a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. The fundamentals are the underlying concepts of accounting, concepts that guide the selection of events to be accounted for, the measurement of those events, and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards. (FASB, 1976, p.2)

The conceptual framework project was described as, "... set[ting] the course for financial accounting and reporting for many years" (FASB, 1976, p1), and the FASB's conceptual framework development has led the way and provided a model for those countries undertaking similar projects. Initially it related to businesses only and the first three concepts statements referred only to the business sector[3]. Later, however, the conceptual framework project was extended to include the

[3]The first three concepts statements were: SFAC1: Objectives of Financial Reporting by Business Enterprises (November 1978); SFAC2: Qualitative Characteristics of Accounting Information (May 1980); SFAC3: Elements of Financial Statements of Business Enterprises (December 1980).

nonprofit sector. This was a result of concerns about financial reporting in the nonprofit sector and a research study (Anthony, 1978) sponsored by the FASB.

3.5 FINANCIAL REPORTING IN THE NONPROFIT SECTOR

At the beginning of the century in the United States all organizations had the option of using either fund accounting[4] or accrual accounting (Figlewicz et al, 1985). However, in the 1920s this began to change. The business sector began to move exclusively to accrual based accounting (Figlewicz et al, 1985; Anthony, 1989) Reasons for this included the effect of the Revenue Act of 1918 which required an accrual approach to calculating taxable income (McGee, 1984), and changes in the source of finance for businesses from short term bank loans to the issue of stocks and bonds. These changes resulted in the focus of attention to financial reports of businesses moving from assessment of short term liquidity, as required by bankers, to earning power, as required by investors (Littleton, 1953) and to a focus on income for taxation purposes.

The stewardship aspect of accounting came to be dominant in the nonprofit sector which had no investor class. Resource providers, who tended to be a few wealthy patrons, were considered happy with the stewardship reporting provided by cash based fund accounting. However, from the 1950s the nonprofit sector developed a larger resource provider base including government, corporate donors and increasing numbers of individual donors. Prior to the early 1970s the accounting profession neglected the nonprofit sector (Sprouse, 1988), but the larger resource provider base led to increased demands for accountability and the fund accounting statements being provided began to be seen as inadequate because

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[4]Fund accounting involves stewardship concepts by providing a record of cash received and disbursed (Figlewicz et al, 1985). It may be traced back to the Roman Empire, and in England one of its uses was to allow Parliament to monitor the monarchy (Herzlinger & Nitterhouse, 1994).

they focussed on compliance as opposed to financial viability (Figlewicz et al, 1985; Weinstein, 1978).

Resources of a for-profit organization may be used in any way likely to be of benefit to the organization and its owners. Resources of a nonprofit organization, however, although intended for the purposes of that organization, may be subject to donor imposed restrictions. Such restrictions may require specific limited uses of resources such as types of expenditure, specific purposes or to cover specific time periods (Herzlinger & Nitterhouse, 1994).

Fund accounting treats the funds of a nonprofit enterprise:

> ... like a collection of cookie jars in which resources for various purposes are stored. ... the fund accounting statements provide three essential pieces of information on resources: their purpose, the legal limits on their use attached by the donors, and the revocable decisions made by the board on their use. (Herzlinger & Sherman, 1980, p95-96)

The function of fund accounting is to ensure that restricted funds are utilized for the required purposes (McIntosh, 1992), and, in the United States, there is a legal requirement that restricted and unrestricted funds be kept separated in the accounting records (Herzlinger & Sherman, 1980). Vatter (1947) developed a fund theory of accounting and a summary of his work is included in Appendix 1.

In 1974 the accounting advisory committee to the Commission on Private Philanthropy and Public Needs (Filer Commission), addressed recommendations to both the Commission and to the accounting profession (Figlewicz et al, 1985).

The committee considered that "accounting methods employed by nonprofit organizations were not codified, were outdated, and could result in abuses of financial disclosure" (Weinstein, 1978, p1005). Its major recommendation was that "... a single uniform set of accounting principles be adopted and followed by nonbusiness organizations" (Figlewicz et al, 1985, p.81). This recommendation arose from concerns over the number of alternative accounting principles available to nonprofit organizations (Gross, 1975), and the large number of financial reports presented for the parts of a nonprofit organization without focussing on the organization as a whole (Weinstein, 1978). The report to the Commission and accounting profession stated that (Gross, 1975):

- charitable organizations have a responsibility for financial disclosures equal to that of public companies;
- the absence of meaningful financial information leads to concern over the use of charitable funds;
- a method of measuring and reporting on the effectiveness of charitable efforts would be a major improvement.

The reasons for recommending a single uniform set of accounting principles for the nonprofit sector were (Gross, 1975, p27):

- it would enable comparisons to be made of the financial reports of different organizations[5];
- non-accountants would find it easier to understand a single set of accounting principles;
- financial reporting would become more objective;
- following the same basic accounting principles and reporting practices makes sense.

The American Institute of Chartered Public Accountants (AICPA) had already issued three industry specific audit guides and recommendations[6], but these were inconsistent in parts (Gross, 1975). Little immediate progress was made to develop a uniform set of accounting principles but the AICPA issued a further accounting guide in 1978, SOP 78-10 *Accounting Principles and Reporting Practices for*

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[5]The Trueblood report was quoted to justify the ability to compare financial reports, "the essence of economic decisions is choice among possible courses of action. Choice requires awareness of the opportunities offered by alternatives. Financial information should facilitate the comparisons needed to make investment and other decisions" (Gross, 1975, p 27).

[6]These were: Hospital Audit Guide (1972), Audits of Colleges and Universities (1973), Audits of Voluntary Health and Welfare Organizations (1974).

Certain Nonprofit Organizations[7]. This also had some inconsistencies with the other publications but it was developed to provide guidance over the expected long period during which a conceptual approach was to be taken (Weinstein, 1978).

3.6 CONCEPTS FOR THE NONPROFIT SECTOR

The FASB, in 1977, commissioned Anthony to consider the question of a conceptual framework for the nonprofit sector. Anthony took a transactions approach, focussing on types of transactions rather than organizations, and based on the premise that:

> Financial accounting principles as promulgated by the FASB and its predecessor organizations should apply to financial reporting in nonbusiness organizations unless the circumstances or the information needs in nonbusiness organizations require a different treatment of the transaction in question. (Anthony, 1978, p23)

His brief was to produce "... a neutral study of the issues and the pros and cons of the alternative ways of resolving each issue" (Anthony, 1978, piii). The aim was to allow the FASB to decide whether it should become involved in developing accounting concepts for the nonprofit sector (FASB, 1978).

The FASB did decide to become involved and the fourth concepts statement SFAC4: *Objectives of Financial Reporting by Nonbusiness Organizations* was issued in December 1980.

It identified the information financial reports should provide:

- economic resources, obligations and net resources (paras 44-46);

[7]Weinstein (1978) discussed the views of those who had developed this guide. He noted that those who had been heavily involved in nonprofit accounting tended to prefer retaining aspects of the methods used at the time. "They would be heard to discuss the 'principles of fund accounting'" (p1007). With respect to fund accounting he observed: "This form of accounting has evolved in such a way that those who manage nonprofit organizations could use its many twists and turns to obscure and confuse, not to enlighten. This was never intended, of course, but it has happened because the accounting profession has largely neglected the development of accounting principles in the nonprofit sector" (p1009).

- organization performance: "changes in the amount and nature of net resources ... and information about the service efforts and accomplishments" (para 47);
- nature of and relation between inflows and outflows: "distinguish[ing] resource flows that change net resources ... from those that do not change net resources" (para 48) and "distinguish[ing] between resource flows that are related to operations and those that are not[8]" (para 49).

Included in SFAC4 was a comparison of the objectives of financial reporting for business organizations and nonprofit organizations which noted the importance of stewardship information and that "there often is a more direct relationship between resource providers and the entity than for a business enterprise" (FASB, 1992a, SFAC4, Appendix B, para b2). It also outlined significant changes from the exposure draft, one of which was a "greater emphasis on distinguishing flows that affect operations from those that do not" (para 49) but the comparison in Appendix B omitted the information referred to in paragraphs 48 and 49.

SFAC4 considered the characteristics and limitations of financial reporting for the nonbusiness sector. It noted that financial reports depict economic events quantified in money and that information in terms other than money may be required to assess performance of such an organization (FASB, 1992a, SFAC4, paras 26-27).

> This statement sets forth two performance indicators for nonbusiness organizations: information about the nature of and relation between inflows and outflows of resources and information about service efforts and accomplishments. (FASB, 1992a, SFAC4, para 9)

It was, however, noted that provision of information on service efforts and accomplishments was "generally undeveloped" and that in the absence of such

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[8] A footnote at this point states: "Resource flows that are not related to operations have been described in various ways, for example, as 'nonexpendable,' 'capital,' or 'restricted' flows. The Board's endorsement of distinguishing these types of flows is not intended to prejudge future determinations of (a) the criteria that should be used in making this distinction and (b) how and in what financial statements different types of flows might be displayed" (FASB, 1992a, SFAC4, para 49).

measures other information could be supplied such as "managers' explanations and sources other than financial reporting" (FASB, 1992a, SFAC4, para 53).

3.7 EXTENSION OF CONCEPTUAL FRAMEWORK

Out of the discussion in SFAC4 the FASB decided that one conceptual framework would be appropriate for all entities (FASB, 1983, pvii), and began a reconsideration of its concepts statements SFAC2: *Qualitative Characteristics of Accounting Information* and SFAC3: *Elements of Financial Statements of Business Enterprises* in order to incorporate the nonprofit sector.

Anthony (1978) had categorised nonprofit organizations into two types distinguished by sources of financial resources:

- Type A, predominantly financed by selling goods and services; and
- Type B, predominantly financed by "non-reciprocal transfers" such as grants, contributions and taxes (Anthony, 1978, p9).

He had suggested that the concepts developing for business organizations were appropriate for Type A organizations but noted differences affecting accounting in Type B organizations:

> One problem is how to account for nonrevenue resource inflows ... A second problem is how to account for restrictions on spending, including the need for distinguishing between operating resource inflows and capital inflows. This is a difficult problem, and a conceptual basis for solving it needs to be developed. ... Except for these few differences, financial accounting concepts are said to be essentially the same for both business and nonbusiness organizations. In both, there is the need to separate operating transactions from capital transactions. In both, the concept of capital maintenance is important. (Anthony, 1978, p171)

In 1983 the FASB issued an exposure draft proposing amendments to SFAC2 and SFAC3 to apply them to nonprofit organizations as well as business organizations (FASB, 1983). That exposure draft proposed three new elements of financial statements (FASB, 1983):

- net assets (divided into two classes - restricted and unrestricted);
- contributions; and

- change in net assets which was considered to be the equivalent of comprehensive income.

Following a public hearing in November 1983 the FASB acknowledged concerns expressed about contributions. These concerns related to the recognition of contributions and the way they would be presented in financial reports (FASB, 1984). The FASB later announced that the proposed new elements, contributions and changes in net assets, would not be introduced. The need to distinguish between restricted and unrestricted transactions was later discussed (FASB, January 1985) and net assets were extended from two classes to three:

> The importance of donor-imposed restrictions on resources provided to not-for-profit organizations requires a focus on information about changes in their net assets that is different from the owner-nonowner focus for business enterprises. That difference requires information that distinguishes three fundamental kinds of changes in net assets of not-for-profit organizations - changes affecting permanently restricted, temporarily restricted, and unrestricted net assets. Changes in each of those three broad classes of net assets are composed of revenues, gains, expenses, and losses as well as other events that change the nature of those classes of net assets. (FASB, July 1985, p6)

A revised exposure draft was issued in September 1985. Bossio, the FASB's project manager, commented in the November status report that although the classes of net assets were similar to the funds used by the voluntary health and welfare sector, the exposure draft concentrated on classes of net assets, not on particular assets and liabilities that are commonly identified as funds in fund accounting:

> The exposure draft would allow for and perhaps suggests movement from traditional fund accounting toward greater aggregation ... The balance sheets of not-for-profit organizations could evolve to a point that only a ... minority of organizations would continue to classify assets and liabilities among several fund groups. (Bossio, 1985, p6)

Bossio stated financial statement display to be a separate issue but he referred to users of financial reports and discussed the differences between businesses and nonprofit organizations:

> While there are many similarities between the two, there are many differences in reporting objectives. Primarily, the differences stem from the differing needs of external users of financial reports. Investors, creditors, and other users of financial statements of business enterprises are primarily interested in information about company performance measured by earnings and comprehensive income and their

> components. On the other hand, donors, grantors, creditors, and other users of not-for-profit organizations' financial statements are more interested in information about the nature of and relation between inflows and outflows of resources and about service efforts and accomplishments. Donors do not see increasing profitability as an indicator of good performance in the way that investors and creditors of business enterprises do. Although investors, creditors, and donors have different focuses, their similar interests in information about economic resources, obligations, net resources, and changes in them for purposes of making a decision about allocating resources to an entity outweigh their differences. (Bossio, 1985, p4)

Although not apparent at that time, the nature of and relation between inflows and outflows (FASB, 1992a, SFAC4, paras 48, 49) was to be ignored. Bossio showed a multi-columned illustration of changes in net assets[9] to give an example of how the flows of the three classes of net assets may be portrayed. This multi-columned statement showed reclassifications[10] occurring between columns, and these reclassifications were explained:

> No restricted expenses are displayed. Although expenses may be incurred by a not-for-profit organization in performing activities that fulfill a donor stipulation, the expenses themselves are not restricted. ... Two separate events are displayed, the expense that reduces unrestricted net assets and the reclassification that simultaneously increases unrestricted net assets and decreases restricted net assets. (Bossio, 1985, p6)

Restricted contributions were also discussed in relation to differing practices[11] and the definition of liabilities[12]. Bossio acknowledged some controversy over whether restricted contributions were liabilities and noted that some respondents to the first exposure draft had compared these contributions with:

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[9]It was stated that the concepts do not necessarily require a multi-column format.

[10]"Reclassifications between classes of net assets result from donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations. Reclassifications simultaneously increase one class and decrease another class of net assets; they do not involve inflows, outflows, or other changes in assets or liabilities" (FASB, 1992a, SFAC6, para 114).

[11]Some, those following SOP 78-10 were treating restricted contributions as liabilities in financial statements until spent, while others were accounting for such contributions as an increase in net assets by adding them to the "restricted fund balance."

[12]"Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (FASB, 1992a, SFAC6, para 35).

> An advance payment for a magazine subscription (a liability). ... Unlike receipts for products sold in an exchange transaction, gifts are receipts in nonreciprocal transfers. ... [it] will still be necessary to determine whether the proceeds are from a customer purchasing services rather than from a donor providing gifts. ... the Board's liability definition does not encompass the 'restricted gifts' ... The Board's liability definition and discussion of the characteristics of a liability does not require change in practice, ... (Bossio, 1985, p8)

Anthony (1983, 1988, 1989, 1993) disagreed with the FASB's classifications of assets into unrestricted, temporarily restricted, and permanently restricted. He maintained this classification had developed as a result of strong criticism of the July 1983 exposure draft in which the new financial statement element, contributions "... lumped together contributions of all types, from annual dues to endowments, and as a result there was strong opposition to it" (Anthony, 1989, p54). He maintained that the three-way classification of net assets had been "adopted hastily", with the temporarily restricted class being developed as:

> A way of solving what it [FASB staff] thought was a problem relating to one type of contributions - contributions that were advance payments for projects to be conducted in a future year or for some other future purpose. In both business accounting and current practice in many nonprofit organizations, advance payments are treated as liabilities in the year they are received, and they are recognized as revenue in the relevant future year.
>
> The staff concluded, however, that advance payments from contributors are not liabilities. It reasoned that liabilities are obligations, but if the project for which the funds were contributed is not carried out, the organization has no legal obligation to return the money. (Anthony, 1993)

Anthony also disputed the FASB's view that all "resource inflows in the current period be reported as revenue of that period" (p55), maintaining that contributions of plant and endowment are contributed capital.

SFAC6 *Elements of Financial Statements* was adopted in December 1985 and Anthony, who until then had been a member of the nonprofit task force, resigned (Anthony, 1993).

Anthony (1978) had stated a conceptual basis needed to be developed to address differences between business and nonprofit organizations, these differences being (Anthony, 1978, p171):

- accounting for nonrevenue resource inflows; and
- accounting for restrictions on spending.

The FASB resolved this in SFAC6 by:

- defining additions to equity in such a way that all contributions to a nonprofit organization irrespective of the form or restrictions placed on them were classified as income; and
- adapting the fund accounting notion of restrictions to develop three classes of net assets (unrestricted, temporarily restricted and permanently restricted) and developing reclassifications to recognize the release of restrictions.

Although fund accounting practices had been criticized (Weinstein, 1978; Figlewicz et al, 1985), SFAC6 does not preclude fund accounting but it does require that totals for the organization be shown instead of presenting a number of different financial reports for each fund.

The issue of SFAC6 "put the writing on the wall" (Smith, 1987) for major changes to be made to the financial reporting of nonprofit organizations. Bossio, expressing his own views stated, "You could say that it is not the concepts that have implications for changes, it is the diversity in practice that does" (Bossio, 1985, p6).

3.7.1 Controversy over Extension to Non-Profit Sector

There has been some controversy over the extension of the conceptual framework project to encompass the nonprofit sector.

Mautz (1989) proposed that service facilities should not be capitalized because such facilities are used for the purposes of the organization. This purpose involves the transfer of resources from the organization to others rather than the possibility of earning an income from those facilities. He considered the attempts being made to impose the concepts developed for profit seeking organizations to be "too disappointing", recommending experimentation with financial statements which he considered should consist of a statement of expenditure, a statement of sources of funds spent, a statement of net assets available for expenditure (to show adequate reserves but not an overaccumulation), and a statement of service facilities held. Mautz recommended that a separate committee should develop standards for nonprofit organizations.

Herzlinger & Sherman (1980) maintained that there are differences between business and nonprofit organizations in relation to financial structures and objectives, these differences being to such an extent that financial reports produced using a format similar to that used by business organizations would be misleading. They considered fund accounting to be essential for nonprofit organizations and that difficulties understanding the complexity of fund statements would be resolved by education rather than simplification.

> Nonprofit organizations' financial statements should enable their readers to evaluate the following two issues:
>
> (1) Were donated or restricted resources used in a manner consistent with the instructions of those who gave them?
>
> (2) Is the organization financially stable in the sense that the inflow of financial resources is generally equal to or greater than the outflow?
>
> Answering the first question requires fund accounting in nonprofit financial statements that tracks carefully how donated resources were used. (Herzlinger & Nitterhouse, 1994, p185)

Falk (1992) and Beechy & Zimmerman (1992) disagreed with Anthony's transactions approach and categorised the nonprofit sector into those types of organizations that could be included in the conceptual framework project, and those that should not. They considered that the excluded organizations should use fund accounting on a cash or modified cash basis, proposing that fixed asset purchases not be capitalized. Fund accounting was important on the basis that it showed accountability for funds received and would aid giving decisions of patrons, while expenditure was considered to be more important to these organizations than expense. Although the categories each developed were slightly different, they have identified types of organizations or programmes they believe should not be included in the conceptual framework, and these are similar to Anthony's Type B organizations:

- " ... provide products or services for free (or below cost), resulting in an unreciprocated outflow that is balanced by resources received via unreciprocated contributions" (Falk, 1992, p483); and
- " ... offer collective goods with funds provided in fixed amounts by granting agencies" (Beechy & Zimmerman, 1992, p48).

They do, however, acknowledge difficulty differentiating clearly between the organizations they think should and should not use fund accounting on a cash or modified cash basis.

Anthony, himself has been one of the harshest critics (Anthony, 1983, 1988, 1989, 1993). He preferred a focus on income statements for business and nonprofit organizations[13] and has also criticised the FASB for its "asset and liability view" of financial reporting[14]. He says this view is at variance with SFAC1: *Objectives of Financial Reporting by Business Enterprises* which emphasises income. "The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components" (FASB, 1992a, SFAC1, para 43).

Despite the criticisms the project proceeded.

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[13]Anthony considered that a focus on the income statement would show the extent to which financial capital is being maintained; in a business a large reported income would be seen as good, while in a nonprofit organisation a breakeven or small surplus is the aim (Anthony, 1989).

[14] In his 1983 publication Anthony stated that he had been a member of the concepts task force for ten years, and considered one of the problems of the conceptual framework project to be that " ... from the beginning the staff embraced the 'asset/liability' approach to income measurement, even though the majority of respondents to its initial Discussion Memorandum and the majority of task force members favored the 'revenue/expense' approach. ... I do not think the asset/liability approach is an efficient way of thinking about how important conceptual issues should be resolved" (Anthony, 1983, pviii).

3.8 COMPLETENESS OF CONCEPTUAL FRAMEWORK

Conceptual frameworks have also been developed or are being developed in other countries, drawing heavily on that developed by the FASB (Holgate, 1992; Hodgson, Holmes & Kam, 1992; ASB, 1991). Essential similarities of the conceptual frameworks are because they owe much to the FASB framework, and because all of these countries are party to agreements to internationally harmonize accounting standards. Because of these similarities, commentary on the FASB's conceptual framework, which was completed in 1985, is referred to in order to give an indication of views on the completeness, usefulness and application of that conceptual framework.

The FASB's conceptual framework consists of five statements[15] and appears to be considered complete (Gerboth, 1987; Sanborn, 1987; Sprouse, 1988) or relatively complete (Koeppen, 1988), although it has been described as incomplete by others (Heath, 1988; Hines, 1989; Tocco & Vierling, 1990; Daley & Tranter, 1990; Milburn, 1991).

Tocco & Vierling (1990) maintain that the conceptual framework project is incomplete, development having stopped because of differing views over whether a descriptive or normative approach should be used (Tocco & Vierling, 1990, p14), while Daley & Tranter (1990) and Heath (1988) see it as incomplete because it is normative:

> It ... is an incomplete model. Like the matching model, it, too, fails to take into account the political and economic forces that shape accounting standards and practice. It is a normative model of the things the FASB believes **should** be taken into

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[15]SFAC1: Objectives of Financial Reporting by Business Enterprises (November 1978), SFAC2: Qualitative Characteristics of Accounting Information (May 1980), SFAC4: Objectives of Financial Reporting by Nonbusiness Organizations (December 1980), SFAC5: Recognition and Measurement in Financial Statements of Business Enterprises (December 1984), SFAC6: Elements of Financial Statements. - A Replacement of FASB Concepts Statement No. 3 (Incorporating an Amendment of FASB Concepts Statement No 2) (December 1985).

> account in developing accounting standards, not a positive model of the forces that **do** shape them. (Heath, 1988, p104)

Milburn (1991) suggested economic rationality as another aspect of a "fully defined conceptual framework ... [based on] delineating the economic purpose of profit oriented enterprises that should be the measurement objective of financial reporting" (p 44). He considered that the conceptual framework should link capital-based economic theory with accounting recognition and measurement principles (p 48) and that there should be efforts to develop an understanding of the limits of economic reasoning (p 45). These limits of economic reasoning are perhaps also called into question by the continuing progress, and controversy, relating to financial reporting for the nonprofit sector and the extension of the conceptual framework to that sector.

3.9 ASSESSMENTS OF CONCEPTUAL FRAMEWORK

The conceptual framework development has been controversial and subjected to numerous criticisms (Laughlin & Puxty, 1983; Puxty & Laughlin, 1983; Chua 1986; Hines, 1989; Kripke,1989; Ronen & Sorter, 1989; Milburn, 1991).

Miller (1990) described those developing the conceptual framework project as reformers, citing three aspects of reform achieved:

- the FASB intended to be guided by the conceptual framework in standard setting[16] (p.24);
- the conceptual framework put users and decision usefulness first[17] (pp 24,25); and

[16]"The Statements ... will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives" (FASB, 1992a, SFAC4, p752).

[17]"Financial reporting ... should provide information that is useful to ... users in making rational decisions about the allocation of resources to those organizations. The information should be comprehensible to those who have a reasonable understanding of an organization's activities and are willing to study the information with reasonable

- the conceptual framework adopted the "asset and liability" view that would remove justification for matching[18] (including the justification for depreciation as an allocation process) (p26).

Solomons maintained that a "coherent theoretical base" assists in the standard setting process and helps to prevent political interference (Solomons, 1983). On the other hand Gerboth observed:

> A fundamental error ... the mistaken notion that it is possible to avoid, minimize, or control debate on basic issues by prior agreement on abstract principles. ... The flaw in the conceptual framework is simply that it attempts to improve the form and technique of reasoning, and in disciplines that deal with complex human affairs, the form and technique of reasoning are tangential matters. ... The attempt to base accounting decisions on definitions risks ... mechanical decision-making ... For all its logical rigor, it is irrational. (Gerboth, 1987, pp1-2)

Horngren (1981) viewed the FASB as a policy making board stating that the FASB's definition of the conceptual framework as a "constitution" implied the social choices required in policy making. He considered that the "technical framework" the FASB was developing would be (Horngren, 1981):

- helpful at least in providing a common language and approach;
- helpful in some cases but not in others; and
- of little assistance when policy making is a matter of "choosing which".

One hope he did express was that:

> The long-standing clamor for a conceptual framework will diminish because proponents will finally realize that such a framework is only a part of the policy making process, a part whose prominence fluctuates from standard to standard. (Horngren, 1981, p95)

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diligence" (FASB, 1992a, SFAC4, para 35). "The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence" (FASB, 1992a, SFAC1, para 34).

[18] At the outset of the conceptual framework project the perspective to be taken was identified as a major issue. "The questions involve whether revenues, expenses, and earnings (a) should be defined in terms of changes in assets and liabilities that represent an enterprise's economic resources and its obligations to transfer economic resources to other entities in the future or (b) should be defined in terms of perceived needs of earnings measurement regardless of whether or not the related assets and liabilities represent economic resources and obligations to transfer economic resources" (FASB, 1976, p103).

3.10 VIEWS OF FASB MEMBERS

Kirk, a member of the FASB for fourteen years, demonstrated his own changing views towards the conceptual framework. He acknowledged that on his arrival at the FASB he had "little appreciation for the past efforts to develop normative accounting concepts or of the empirical accounting research of the late 1960s" (Kirk, 1988, p9). He believed that "technical accounting standards were needed" and acknowledged:

> Accept[ing] the conceptual framework project in the early years on faith. ... If the development of objectives of financial statements, definitions of the elements thereof, and the other concepts would help show the way by logical deduction to sound and consistent standards, I was all for it. (Kirk, 1988, p12)

Kirk considered that "a conceptual approach best serves the public interest and that standard setting by consensus, compromise or consequences does not serve that public interest" (Kirk, 1981, p84). He also noted the scepticism of some over the use of concepts in standard setting, but pointed out the difficulties for standard setters in the absence of a conceptual framework (Kirk, 1983, p83):

- reality is a personal viewpoint and the conceptual framework would define the aspect to be presented in financial statements;
- different members of standard setting boards would refer to different concepts from those of their predecessors and the conceptual framework would provide guidance;
- political pressures on standard setters would be reduced by a conceptual framework.

Kirk later noted that, while concepts assist by providing a guide for standard setters subjected to political pressures, a normative system has "definite limits", and quoted Horngren's views that, "... a technical conceptual framework is only part of the policy making process. A framework is desirable, but not sufficient" (Kirk, 1988, p17).

Kirk's views apparently changed over the years from very strongly supporting the normative approach of the conceptual framework project, to acknowledging that while concepts provide assistance in the standard setting process, they also have limits. In 1988 he observed, as had Storey (1964) that both analytical and empirical research is needed to assist in standard setting together with wise standard setters (Kirk, 1988, p17).

These views are echoed by other FASB members who have referred to the part played by the conceptual framework in the standard setting process as a "balancing act" between conceptual purity and practical matters (Beresford, 1988; Brown, 1990; Wyatt, 1991). Although Brown describes the process as involving a conceptual view first with practical matters modifying that stance if necessary, Wyatt makes clear that:

> Accounting standards cannot simply flow from an application of logic using the conceptual framework as a foundation. Such an approach may be a useful, or even necessary, starting point in the analysis of a thorny issue, but it is not sufficient in a system that must also consider practicalities. (Wyatt, 1990, p86)

3.11 CONCEPTUAL FRAMEWORKS IN OTHER COUNTRIES

All the conceptual frameworks developed in other countries have drawn on that of the FASB but there are some differences. All except the IASC framework include the nonprofit sector, although additional concepts that were not in the FASB's conceptual framework have been developed:

- The Australian conceptual framework has a concept of the reporting entity that defines the entities required to produce general purpose external financial reports by considering whether there are users reliant on such reports, and the boundaries of the reporting entity by requiring consideration of whether control exists over any other entity.
- New Zealand's conceptual framework includes definitions of non-financial elements and the process of non-financial measurement.

Table 3.1 compares these conceptual frameworks.

TABLE 3.1
Conceptual Frameworks

Country of Standard Setting Authority	Title of Conceptual Framework	Includes Nonprofit Sector	Includes Reporting Entity Concept	Includes Non-Financial Elements
United States	Statements of Concepts	Yes	No	No
Canada	Financial Statement Concepts	Yes	No	No
Australia	Statements of Accounting Concepts	Yes	Yes	No
England	Statements of Principles	Yes	Yes	No
International	Framework for the Preparation and Presentation of Financial Statements	No	No	No
New Zealand	Statement of Concepts for General Purpose Financial Reporting	Yes	Yes	Yes

3.12 IMPLICATIONS FOR THE NONPROFIT SECTOR

The likely direct major effects of the conceptual framework projects on the nonprofit sector relate to the definitions adopted for elements of financial reports, the reporting entity, and the inclusion of non-financial elements.

3.12.1 Definitions of Elements

The conceptual framework projects have moved away from a "matching" concept and taken an "assets and liabilities" point of view. Definitions of assets and liabilities are the key to the definitions of other elements.

The definitions especially affecting the nonprofit sector are: revenue, liabilities, additions to or distributions from net assets and net assets.

a) Revenue

Nonprofit organizations often receive contributions in kind, and these include both goods and services. Commonly these are not accounted for because they involve no historical cost. Charities frequently are staffed by a small paid staff and a large voluntary workforce; Anthony (1978) discussed the pros and cons of accounting for contributed services. The conceptual framework definition of revenue includes revenue of all types:

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. (FASB, 1992a, SFAC6, para 78)
>
> Gains are increases in equity (net assets) from peripheral or incidental transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. (FASB, 1992a, SFAC6, para 82)

Such a definition may result in a requirement to account for non-monetary contributions, including voluntary services, if these are considered to give rise to "inflows or enhancements of assets".

b) Liabilities

Nonprofit organizations frequently receive restricted contributions targeted at a specific activity or aspect of the organization's operations. There have been two most common reporting practices observed in relation to restricted contributions:

- a fund accounting[19] practice is to treat such contributions as revenue of a restricted fund,
- an alternative accounting practice is to treat such contributions as a liability until the conditions are met either under the matching principle or on the basis that a moral obligation exists and the funds would be repaid if not used for the purpose.

[19] Fund accounting has been aligned with the differentiation between unrestricted and restricted funds (Bird & Morgan-Jones, 1981; McIntosh, 1992; Herzlinger & Nitterhouse, 1994) and Anthony (1978) observed strong views that, "the concept of restricted funds is basic to fund accounting ..." (Anthony, 1978, p113).

The conceptual framework projects view restricted contributions as imposing a fiduciary duty but not constituting a liability. This view supports the fund accounting practice requiring restricted contributions to be reported as income, albeit restricted income, on receipt.

Herzlinger & Nitterhouse (1994) considered the existence of restrictions to result in nonprofit organizations needing to meet more extensive stewardship requirements than for-profit organizations and viewed fund accounting as an appropriate way of meeting these requirements.

The effect of this conceptual view is likely to lead to a more widespread use of fund accounting in order to demonstrate that amounts reported as income are restricted. It is also likely to lead to greater fluctuations in the net surplus or deficit reported on the occasions when restricted contributions are spent in a different year from when received.

c) Additions to or Distributions from Net Assets

Nonprofit organizations commonly receive from contributors items considered to be "capital" contributions. Examples are contributions of fixed assets, such as land, money to buy fixed assets, or endowment funds where only the income from these funds may be used. In the conceptual framework the definition of additions to, or distributions from net assets involves owners, acting in their capacity as owners, increasing or decreasing their financial interest in the organization (FASB, 1992a, SFAC6, paras 66-69). Nonprofit organizations are defined as not having owners, and therefore there is no possibility of investment by or distribution to owners (FASB, 1992a, SFAC6, para 52). Such "capital" contributions will be required to be reported as income.

The stance taken in the conceptual framework project has been disputed repeatedly by Anthony (1983, 1988, 1989, 1993). All three of the major research projects into the nonprofit sector (Anthony, 1978; CICA, 1980; Bird & Morgan-Jones, 1981) based their conclusions on the assumption that nonprofit organizations receive "capital" from people who are not owners. An AICPA subcommittee established following the issue of the report of the Commission on Private Philanthropy and Public Needs made the same assumption (Weinstein 1978).

Kerr (1989) in considering the concept of equity devoted a chapter to the nonprofit sector:

> Does the absence of an ownership element in a not-for-profit organization lead to an inference that net assets are created only by revenues and gains exceeding expenses and losses? ... can there be a direct injection of assets, similar, in some way, to a contribution of capital in a business entity? ... It is submitted that any distinction between a gain and a direct contribution of capital would be important only when some measure of income is used as a performance indicator. ... If a concept of income more akin to operating income were adopted, some concept of contributed capital would be needed, and the problem of deciding between, say, grants that are revenue and grants that are to be considered capital contributions would then have to be faced. As not-for-profit organizations are not activated by the profit motive, the concept of income is of little, if any, significance, although some overall measure of surplus or deficit for the period may be required. ... Financial performance indicators for not-for-profit organizations should relate to the goods or services provided by the organization and the resources used in providing them; cost per unit of product or service provided is more appropriate as a performance measure than is some concept of income. (Kerr, 1989, pp60-61)

Kerr's discussion appears to conclude that a lack of significance of a concept of income to the nonprofit sector means there is no need to address the question of distinguishing between contributed capital and contributed income. Although she may be correct in observing that other measures of performance are more appropriate than a surplus or deficit measure, observations of researchers that nonprofit organizations manipulate their financial reporting (Weinstein, 1978; Bird & Morgan-Jones, 1981; Falk, 1981; Figlewicz et al, 1985; Hyndman & Kirk, 1988; Hines & Jones, 1992) give the impression that surplus or deficit reported is seen as a performance measure and that Kerr's perception of what should be the case for performance measures may not be perceived as such. Other observers tend to confirm that the surplus or deficit reported has been seen as a measure of performance:

> A philanthropic organization may be most efficient from a financial standpoint when income and expense are equal. (Gross, 1975)
>
> As a general rule, ... a large net income for a nonbusiness organization indicates that it did not provide as much service as it could have with available resources. (Anthony, 1989, p34)
>
> This figure is possibly viewed by some potential contributors as an indication of the future funding needs of the charity. (Hyndman & Kirk, 1988, p36)

The conceptual framework definition means that contributions which previously would have been reported as capital transactions will be reported in future as income and consequently affect the measurement of net surplus or deficit. But, if that measurement is seen as a measure of performance then, as Kerr (1989) observed, there will be a need to distinguish between grants that are revenue and grants that are capital contributions.

d) Net Assets

Net assets are defined purely as an arithmetical item; the difference between assets and liabilities, and for nonprofit organizations it is noted that net assets do not constitute an ownership interest (FASB, 1992a, SFAC6, para 90).

The FASB conceptual framework has developed three classes of net assets categorized by levels of restrictions; unrestricted, temporarily restricted, and permanently restricted, requiring totals of these classes for the entity and a final total of net assets. This conceptual approach is based on a view that fund accounting is a useful method of data accumulation but that the focus should be on the whole entity (Weinstein, 1978). It differs from the fund accounting approach which has tended to present funds according to specific restrictions, with a separate report for each fund and no total for the whole entity.

The classes of net assets provide the information for the minimum fund segregations legally required, although the conceptual view has been criticized as oversimplification (Herzlinger & Sherman, 1980) and reducing the importance of fund groupings (Smith, 1987).

This classification requirement for net assets, together with the requirement to carry out reclassifications, does not occur in any of the conceptual frameworks other than the FASB's, although there is some agreement that restricted contributions do not constitute liabilities, together with acknowledgement that there are likely to be restrictions on net assets (AARF, SAC4, para 87).

Although fund accounting is used to some extent in the other countries surveyed, it is not specifically addressed in the conceptual framework documents. SFAC 6 requires reports covering totals for the entity in the financial statements, and a similar requirement may be assumed in the other countries.

If such classes of net assets are used then the net surplus or deficit reported would require analysis into those three classes for transfer to net assets. In addition, further reclassifications would be required where restrictions are met other than by the income and expenditure reported (McLaughlin & Farley, 1989). Examples of the release of these restrictions would relate to such events as the expenditure of restricted contributions received for the purchase of fixed assets. As observed in respect of liabilities a more widespread use of fund accounting is predicted.

3.12.2 Reporting Entity

The concept of the reporting entity requires the identification of the whole reporting entity by deciding whether there are users dependent on general purpose financial reports.

Many nonprofit organizations operate in a fragmented manner (Weinstein, 1978; Holder, 1986). With respect to philanthropic and voluntary health and welfare organizations Holder observed two ways in which the organizations tended to be fragmented:

- some are "composed of a national organization and numerous local chapters or divisions" (p76);
- some "establish separate legal entities for purposes of (1) fund raising and (2) holding endowment-type resources" (p78).

Anthony (1978) excluded the question of the boundaries of the entity from his research study and, as a concept, the boundaries of the reporting entity have not been considered in the conceptual frameworks of the United States, Canada, or the IASC.

Australia, however, developed a concept of a reporting entity:

> Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources. Reporting entities shall prepare general purpose financial statements. (AARF, SAC1, paras 40-41)

The discussion section of this concepts statement includes identifying whether dependent users exist, and implications for groups of entities, noting that identifying the boundaries of the reporting entity is related to the reporting entity concept. New Zealand and the United Kingdom have also adopted this concept.

Identification of Dependent Users

SAC 1: *Definition of the Reporting Entity* states that it is likely to be obvious whether there are dependent users of financial reports, however, if there is a need to consider this matter the following factors are given as examples to consider:

- whether there is separation of the management from those with an economic interest;
- whether the entity has any economic or political importance;

- financial characteristics such as size. "In the case of non-business entities ... the amount of resources provided ... by ... other parties to the activities conducted by the entities should be considered" (AARF, SAC1, paras 19-22).

Under Australia's conceptual framework, the reporting entity concept requires that if dependent users exist then general purpose financial reporting is required and there is no separate differential reporting concession. Nonprofit organizations often raise funds from the general public, who may be considered dependent users of financial reports. It seems likely, therefore, that such organizations would be considered reporting entities and required to produce general purpose financial reports.

Boundaries of the Reporting Entity

Australia's reporting entity concept defines the boundaries of the reporting entity by including all controlled entities:

> 'Control' means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity. (AARF, SAC1, para 6)

In his research monograph *Definition of the Reporting Entity*, Ball (1988) recommended that the "concept of control be operationalized as the ability to direct deployment of resources and enjoy the benefits of that deployment" (px). He does not state whether the enjoyment of benefits is an economic enjoyment in that the reporting organization controls and/or receives financial benefits from a subsidiary's activities, or whether that enjoyment is an enjoyment of some other form. The definition of control in the reporting entity concept, however, makes no reference to enjoyment of benefits, merely to achieving the objectives of the reporting entity. Where control, as defined, exists then the controlling and controlled entities comprise an economic entity (AARF, SAC1, para 16).

In respect of charities this requires some clarification. The objectives of a charitable entity may not be economic ones and there may be no economic benefits flowing to the reporting entity as Ball proposed. There may, however, be some control of decision making to the extent that the other entity is operating, or co-operating, with the reporting entity to achieve its objectives. An example of such control may relate to a requirement for approval of any changes in rules.

Ball (1988) observed that the commonly understood view of control, in the corporate sector, could in many cases be decided by:

- "power to determine the composition of the board of directors of the potential subentity;
- power to determine the casting of a majority of the votes in the potential subentity" (Ball, 1988, p58).

He noted that for "non-corporate entities" the range of methods of control is greater, with other sets of criteria requiring consideration. He included a list of examples of these other criteria for guidance[20] and grouped them into three types:

- financial interdependence;
- selection, appointment and removal of management, including the governing body;
- power to direct operations (Ball, 1988, pp58-59).

Although Ball proposed that control should involve the reporting entity "enjoying benefits" to be derived from controlling a subsidiary entity, the criteria he proposed for determining the existence of control do not require such benefits to be evident.

The concepts statement refers to criteria similar to those Ball proposed:

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[20]The full list of examples provided by Ball are in Appendix 2

> Whether one entity has the capacity to control other entities, and therefore whether an economic entity exists, will depend on an evaluation of the circumstances of the particular entities. In determining whether control exists, the factors to be considered include the following: extent and implications of financial interdependence, capacity to appoint or remove managements or governing bodies, and power to direct operations. (AARF, SAC1, para 17)

Having adopted a different definition of control from the one Ball proposed, the concepts statement adopts Ball's criteria for determining control. Consequently neither the definition nor the criteria require the reporting entity to "enjoy the benefits" of control.

For nonprofit organizations which are fragmented the boundaries of the reporting entity require consideration. This will require decisions as to the presence or absence of control over those fragments, and possibly a requirement that consolidated financial reports be produced.

3.12.3 Non-Financial Elements of General Purpose Financial Reports

The accounting advisory committee to the Commission on Private Philanthropy and Public Needs observed that, " ... financial reporting would be improved if the effectiveness of philanthropic effort could be measured, but [the committee] has considered the subject to be beyond the scope of its work" (Gross, 1975, p 27).

The FASB, and others, have acknowledged that although the reported net surplus or deficit is not a measure of performance, and information about service efforts and accomplishments is, there had been little done to develop such reporting.

New Zealand's conceptual framework includes definitions of the non-financial elements of: inputs, outputs and outcomes and this development is a result of incorporating the public sector in its accounting concepts. In assessing performance it states that an entity:

> Is assessed by comparing the entity's financial results with its financial objectives and comparing the entity's service performance results with its service performance

> objectives. Service performance objectives and results are reported in non-financial terms, such as quantities of goods and services provided. ... Where service performance objectives predominate, entities report primarily in non-financial terms. (NZSA, 1993c, SC, para 3.2)

Although these definitions and uses of non-financial elements were initially developed for, and adopted by the public sector, New Zealand's conceptual framework does not limit them to that sector. Considering the comments by the FASB and Kerr (1989) about performance measurement for the nonprofit sector, it seems reasonable to assume that they will eventually be extended to include the nonprofit sector as well.

At a convention held by the New Zealand Society of Accountants in November 1992[21], the papers presented demonstrate clearly the developmental nature of this type of reporting which appears still to be largely experimental[22].

It is to be noted that staff of the auditor-general are working with the New Zealand Society of Accountants to develop solutions to problems encountered (Chapman, 1993). The public sector in New Zealand is required by law to produce statements of service performance, and therefore skills are being built in this area currently. Despite agreement that some way of measuring and reporting on the performance of charities would be extremely helpful, it is suggested that this aspect of New Zealand's conceptual framework should not be extended further while it is experimental.

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[21] The convention was titled *The Public Sector Challenge: Defining, Delivering and Reporting Performance.*

[22] In his report to parliament in August 1993, the auditor general noted that for the 1991-92 annual financial reports of 87 regional and local authorities, only eight received no audit qualification in relation to their statement of service performance. Although he expected considerable improvement in the next financial year, and observed an improvement over the previous year he advised of the formation of a working party to "focus on issues such as the exact purpose of the statements, the focus and amount of detail that should be included in them, the audience to whom they are addressed, and the link between publicly released information and management information" (Chapman, 1993, p14).

3.13 SUMMARY

Conceptual frameworks have been developed or are being developed in all of the countries examined in this study, and these conceptual frameworks are essentially similar. The conceptual framework developed by the FASB led the way for the other countries and began as a normative approach to guide standard setting, apparently in response to perceived shortcomings of the descriptive approach and financial reporting in the 1960s.

The conceptual framework of the FASB and those of other countries are considered by some to have a number of shortcomings. These shortcomings include incompleteness in the failure to take political and economic forces into account and the failure to consider the bounds of economic reasoning.

FASB members acknowledge that a normative approach such as that of the conceptual framework project, while it may assist in standard setting, is inadequate if used alone. Empirical research, the perspectives of constituents, and wise standard setters are needed also.

Concerns expressed about financial reporting of the nonprofit sector led to the FASB's conceptual framework project incorporating that sector on the grounds that there are a large number of similarities between the nonprofit and business sectors. Some critics have argued that this inclusion is inappropriate, at least for parts of the nonprofit sector but they have also acknowledged difficulty differentiating clearly among those parts of the nonprofit sector that should fit into the conceptual framework and those that should not.

In expanding the conceptual framework to encompass the nonprofit sector the FASB was required to address differences between business and nonprofit organizations. These differences related to transactions commonly accounted for in the nonprofit sector as direct additions to equity and contributions received with restrictions attached.

It defined additions to or distributions from equity as involving owners with a financial interest in the organization. This effectively defined all contributions to a nonprofit organization irrespective of source or purpose as income. Fund accounting concepts were adopted, and adapted, to deal with contributions with restrictions attached.

The definition of net assets requires for those nonprofit organizations using fund accounting that the totals of all fund movements be reported in the financial reports.

The effects of the FASB's development of its conceptual framework to encompass the nonprofit sector are likely to include more widespread use of fund accounting, increases and wider fluctuations in reported surpluses and possibly a requirement to account for such non-monetary contributions as contributed services.

The FASB considered that net surplus or deficit is not a measure of performance of nonprofit organizations, but that although there are differences in the focus of the users of financial information of nonprofit organizations and businesses, both sets of users require "... information about economic resources, obligations, net resources, and changes in them for the purposes of making a decision about allocating resources to an entity" (Bossio, 1985, p4). The FASB also referred to the relation between inflows and outflows of resources, and to distinguishing resource flows related to operations as being important. Information about service efforts and accomplishments of a nonprofit organization together with the financial reports were considered to provide the most useful information to assess its performance but the FASB acknowledged there had been little achieved in developing and specifying such information. Despite the lack of development of such additional reports, the FASB modified its conceptual framework to include the nonprofit sector, and this inclusion is reflected in the conceptual frameworks of Canada, the United Kingdom, Australia and New Zealand.

The view that net surplus is not a measure of performance conflicts with earlier views expressed that it is and with research findings that nonprofit organizations tend to manipulate the surplus or deficit reported.

The concept of the reporting entity as developed in Australia defines the boundaries of the reporting entity by reference to control of other entities. This may lead to massive consolidations required from those organizations with multiple divisions or branches.

Clearly, the implications of the conceptual framework projects indicate the likelihood of major changes to financial reporting in the nonprofit sector, partly as a result of attention being drawn to a previously neglected and overlooked sector, and partly as a result of the normative derivation of the conceptual frameworks.

CHAPTER 4

REGULATION OF FINANCIAL REPORTING OF CHARITIES

4.1 INTRODUCTION

Chapter 3 examined the conceptual framework projects, noting that all, except that of the International Accounting Standards Committee, include the nonprofit sector and their marked similarities. Because of this, and because of stated intentions to internationalize accounting standards, substantial similarity in accounting standards promulgated may be predicted.

This chapter begins by considering the beneficiaries of the internationalization process and the attitudes of the International Federation of Accountants towards the nonprofit sector. It then reviews and compares aspects of the accounting standards developed and being developed to cover the nonprofit sector generally, or charities in particular, as is occurring in the United Kingdom.

Governmental regulation of financial reporting by charities differs from country to country, as does the amount of scrutiny they are subjected to by organizations such as consumer watchdog groups. There are also taxation and fund raising concessions granted to charities. The criteria to be met in order to receive those concessions, and the ongoing reporting requirements imposed on charities in order to retain those concessions are reviewed. The extent to which financial reporting requirements have been enforced by the audit process is also considered.

4.2 INTERNATIONALIZATION OF ACCOUNTING STANDARDS

Internationalization of accounting standards is for the benefit of multinational businesses in that decision making would be improved by producing comparable financial statements (Aitken & Wise, 1984; Wyatt, 1989; Boreham,1991). The calls for internationalization of accounting standards arise from the globalization of capital markets, with the regulators of those markets possessing the power to approve or undermine accounting standards (O'Malley, 1992).

Nonprofit organizations are also developing the characteristics of global enterprises (Advisory Committee on Voluntary Foreign Aid, 1992), however, the IASC has not included the nonprofit sector in its conceptual framework, nor has it produced any special accounting or auditing guidance for such organizations. Moreover the IASC does not currently intend to do so, as indicated in an address by a representative of the International Federation of Accountants to the International Committee on Fundraising Organizations (Buisman, 1992, p19):

> The problems of both fund raising organizations and business enterprises are the same, when brought back to the two main questions:
>
> - did all the money come in?
>
> - was it all spent right?

Buisman further observed (p24) that the activities of fundraising organizations are not necessarily measurable in money, and suggested that financial information could be presented in ways other than the traditional ways together with non-financial information. He recommended that the International Committee on Fundraising Organizations contribute to improved reporting by providing guidance, perhaps in co-operation with organizations such as the IASC (Buisman, 1992).

The IASC has been in existence for some twenty years but recently increased efforts have been made to internationalize accounting standards as a result of demands from those participating in international capital markets (Beresford, 1992).

Beresford believed that individual differences in countries are an impediment to the internationalization of standards and outlined a strategy for enhancing what he considered to be a lengthy internationalization process:

> While comprehensive internationalization should be the ultimate goal, the adoption by two or more countries of a common improvement to their existing accounting standards represents an enhancement of international comparability. That implies not only working with international organizations, but also with other national standard-setting organizations. (Beresford, 1992, p9)

This strategy is occurring, encouraged by such trade treaties as the North American Free Trade Agreement which involves the United States, Canada and Mexico, and the Closer Economic Relations agreement between Australia and New Zealand (Sharpe & McGregor, 1993).

All of the individual countries surveyed have included the nonprofit sector in their conceptual frameworks, and have gone some way towards developing standards to account for types of transactions of specific importance to the nonprofit sector. However, the aims and attitudes evident at the international level, together with the exclusion of the nonprofit sector from the IASC's conceptual framework, indicate that special aspects of the sector may be overlooked in the internationalization process.

4.3 ACCOUNTING STANDARDS

A conceptual framework provides guidance for accounting standard setters. Brown (1990) states that when setting standards, a conceptual approach is taken first. Other moderating factors, such as the views of constituents and the judgement of standard setters, are taken into account during the standard setting process. A consequence of taking these moderating factors into account is that standards developed from the conceptual framework will not necessarily reflect the concepts exactly.

Although at an international level the nonprofit sector is considered to be no different from business organizations, all of the individual countries surveyed have considered special aspects of accounting for the sector, as shown in table 4.1.

TABLE 4.1
Documents Related to Special Aspects of Accounting for Nonprofit Organizations

Country	Document Reference	Document Title	Issue Date	Effective Date
United States	SFAS:116 (Standard)	Accounting for Contributions Received and Contributions Made	June 1993	15 Dec 1994
	SFAS:117 (Standard)	Financial Statements of Not-for-Profit Organizations	June 1993	15 Dec 1994
Canada	Re-exposure Draft	Non-profit Organizations	December 1993	
Australia	SAC4 (Concepts)[1]	Definitions and Recognition of the Elements of Financial Statements		
United Kingdom	SORP2 (Exposure Draft)	Accounting by Charities (Charity Accounting Review Committee (CARC) to replace previous SORP2)	March 1993	

A number of possible accounting implications for the nonprofit sector were identified in chapter 3 and these result from the conceptual frameworks developed. This section traces those implications through the standard setting process, considering the extent to which the standards developed and developing resemble the concepts and whether other secondary effects may be discerned.

[1]It was intended in Australia that the Statements of Concepts would have the force of standards in those situations where there were no standards already in existence. No standards had been developed for nonprofit organizations and an appendix to SAC4 *Definition and Recognition of the Elements of Financial Statements* provided an interpretation of the statement for nonprofit organizations. In 1993 it was announced that the status of the Statements of Concepts would be reduced to providing guidance only. It is assumed that Australia will eventually issue a standard covering transactions such as contributions that are common in nonprofit organizations.

There are six important issues. They are:

- contributed services;
- restricted contributions;
- additions to and distributions from net assets;
- presentation of financial reports;
- net assets; and
- reporting entity.

These are considered in more detail below.

4.3.1 Revenue - Contributed Services

Nonprofit organizations frequently make use of contributed services. The conceptual definitions of revenue are not confined to monetary items, but variously refer to service potential, enhancements and future economic benefits (AARF, SAC4, para 95; FASB, 1992a, SFAC6, para 78). If contributed services are considered to give rise to service potential or future economic benefits they will require recognition in the financial reports.

The FASB began consideration of contributed services in 1987 by surveying preparers and users of financial reports.[2] It announced a tentative decision (FASB, April 1988) that contributed services should not be recognized unless they create or enhance an asset. It appeared at this stage that the FASB considered contributed services other than those enhancing an asset, not to be revenue[3].

[2]The reported results of this survey were that: 68% of preparers received contributed services but only 8% accounted for them. 49% of users occasionally obtained information about contributed services but only 7% usually obtained such information from the financial reports. A majority of users and preparers thought information on contributed services (without calculating a dollar value) would be useful, while 13% of users and preparers considered it useful or cost beneficial to recognize contributed services in the financial reports (FASB, 1989).

[3]The FASB instructed its staff to differentiate between goods and services (FASB, April 1988).

An exposure draft (FASB, 1990) proposed recognition of a portion of contributed services using restrictive criteria[4], and encouraged recognition of the remainder. The FASB's project manager (Bossio, 1991a) explained the reasoning for this stating that in concept all contributed services are revenue and should be recognized in the financial reports. Although this view has some support[5], Bossio acknowledged that a requirement to recognize all contributed services was unlikely to be acceptable (Bossio, 1991a). The proposal in this exposure draft was rejected, apparently because of measurement difficulties (Beresford & Bossio, 1992), user scepticism and cost benefit concerns (FASB 1993b, SFAS116, para121).

The FASB issued a second exposure draft (FASB, 1992c) followed by SFAS116 *Accounting for Contributions Received and Contributions Made* (see table 4.2) in which the restrictive criteria were limited further and recognition of the remaining contributed services disallowed although encouraged as a disclosure in the notes (FASB, 1993b, SFAS116).

Table 4.2 compares the proposals of the surveyed countries for the accounting treatment of contributed services. All appear to consider contributed services to be revenue but only the United States requires partial recognition of those services, while the others allow the option. Concerns have been expressed over the value judgement involved in deciding which services to recognize (Alexander, 1991), and that partial recognition would result in misleading financial reports (Anthony, 1978; Booth & Paterson, 1982).

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[4]Contributed services are to be recognized if the services received (a) create or enhance other assets, (b) are provided by entities that normally perform those services for compensation, or (c) are substantially the same as services normally purchased by the recipient (FASB, 1990).

[5]Dalsimer (1986, 1989) considers that only by recognizing contributed services can the true cost of services be seen.

TABLE 4.2
Recognition of Contributed Services as Income

Country	Accounting Treatment
United States	Recognize at fair value if: (a) create or enhance non-financial assets or (b) if requires specialised skills, provided by individuals possessing those skills, and needs to be purchased if not donated. Do not recognise other contributed services although encouraged to disclose at fair value (FASB, 1993b, SFAC116, para 9).
Canada	May choose to recognize when fair value can be estimated, when the services are used in the normal course of the organization's operations and would otherwise have been purchased (CICA, 1993, para .254).
United Kingdom	Recognize only if would otherwise have to purchase (Valuation method is not clearly stated but appears to be at reasonable estimate of value to the charity) SORP2 (CARC, 1993)
Australia	Silent SAC4 definition of contributions, "non-reciprocal transfers of service potential or future economic benefits to an entity" (AARF, SAC4, Appendix para 30).

The FASB issues extensive documentation during its decision processes. None of the other countries surveyed do this and the impression given is that they draw heavily on the work of the FASB, modifying its decisions as desired. This apparent reliance on the FASB is similar to that observed in the conceptual framework development.

It is instructive to compare the FASB's documentation of its decision process in respect of contributed services with aspects of its conceptual framework and with some of the commentary on the conceptual framework. These comparisons refer to:

- the decision usefulness focus of the conceptual framework and the qualities of information;
- the definition of contributed services as revenue and the limits of the conceptual framework;
- the partial recognition criteria proposed and the effect of the FASB's definitions; and
- the link between pre-existing practice and the FASB's standard.

Contributed Services as Decision Useful Information

"Decision usefulness is the entire conceptual framework; all the rest is commentary" (Alexander, 1980). The FASB's conceptual framework proposes decision useful financial reporting and was considered revolutionary for this approach (Miller, 1990). This decision usefulness focus considers information useful to users as most important (Ijiri, 1983). The framework bases the information to be reported on a combination of three qualities;

- two primary qualities of relevance and reliability; and
- one secondary quality, comparability.

That secondary quality is said to interact with the primary qualities to increase the decision usefulness of financial reports (FASB, 1992a, SFAC2, para 33). The need to trade off the degree to which both relevance and reliability may be represented is acknowledged but, although it is considered that neither one should be dispensed with, it is not clear how such a trade off should be made (FASB, 1992a, SFAC2, para 43).

The concept of decision usefulness relates back to the 1960s. The American Accounting Association (1966) took a user oriented view of accounting theory and outlined standards for accounting information: relevance, verifiability, freedom from bias, and quantifiability (AAA, 1966, p8). It maintained that:

> The required degree of adherence to each standard is conditioned by the degree to which the other standards are met. ... Both the minimum conformity required with any one of the standards and rates of substitution (trade-off) among the four standards are conditioned by the circumstances. (AAA, 1966, p10)

Sterling (1967) questioned the application of these standards as, by emphasizing one standard or another, the authors had managed to justify the use of both historical cost as verifiable and current cost as relevant. Sterling sought a better justification than was given by the authors for their stand noting a lack of clear and convincing argument:

> In short, my plea is for a demonstration that current cost is relevant. Without the demonstration there is the danger that relevance and irrelevance can be tossed about as "appropriately match" has been in the past. (Sterling, 1967, p109)

Sterling's request for adequate justification resounds when closely examining the process followed by the FASB in developing its requirement for the partial recognition of contributed services.

The FASB surveyed both users (175) and preparers (5500) of financial reports for their views on contributed services (FASB, 1989). The response of users to the survey is reported as:

> Users ranked measuring contributed services through use of a "dollar value assigned" as least relevant and least reliable, whereas they ranked "description of the kinds of services provided through volunteer efforts" as most relevant and most reliable. Eighty-seven percent of the users of financial statements of not-for-profit organizations stated that they do not believe benefits gained by requiring the assigning and reporting of dollar values for contributed services would outweigh the costs to provide that information. (Adams, Bossio & Rohan, 1989, p23)

Despite this revelation of user opinion in its own survey the FASB proceeded with a requirement for recognition of contributed services:

> All contributions should be recognized ... regardless of the nature of the item donated. That belief is based on certain fundamental views - among them, that accounting standards should result in information that is useful, comparable, and complete ... complete information is considered essential to reliable reporting ... (Bossio, 1991a, p6) (emphasis added)

An examination of these justifications highlights inconsistencies:

- useful: the FASB's own survey demonstrated that the information was not useful;
- comparable: this is a secondary characteristic of decision-useful information. The primary characteristics of relevance and reliability were dismissed by users;
- complete: completeness is not one of the qualitative characteristics although Bossio uses it to claim that completeness is necessary for reliability.

Later, relevance is cited as justification for partial recognition of contributed services:

> Clearly relevant, clearly measurable, and obtainable at a cost that does not exceed the benefits of the information provided. (FASB, 1993b, SFAS 116, para 121)

Over the time this standard has been developing, in addition to decision usefulness, each of the qualitative characteristics has been claimed as justification for the Board's view, although no balanced view of the trade off among those qualities has been given.

Sterling's request to the American Accounting Association could be paraphrased and directed to the FASB:

> In short, my plea is for a demonstration that [partial recognition of contributed services] is relevant. (Sterling, 1967, p109)

Contributed Services as Revenue

Milburn (1991) considered the conceptual framework incomplete, calling for efforts to develop an understanding of the limits of economic reasoning. The FASB has developed its conceptual framework using an economic[6] focus and its definition of a conceptual framework includes a reference to the limits of financial accounting (FASB, 1976). However, the FASB has not defined what it means by economic and has not addressed the limits of that economic focus.

It appears that initially the FASB did not define all contributed services as revenue (FASB, April 1988). It was not until after the results of the user survey were received that all contributed services were declared to be revenue (Bossio, 1991a).

A later definition of contributions states contributed services to be an inflow of assets. "A contribution is an unconditional transfer of cash or other assets to an entity ... in a voluntary nonreciprocal transfer ... Other assets include ... services ..." (FASB, 1993b, SFAS116, para 5).

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[6]"Financial reporting is not an end in itself but is intended to provide information that is useful in making economic decisions - for making reasoned choices among alternative uses of scarce resources" (FASB, 1992, SFAC4, para 13).

The FASB's view of contributed services would likely be questioned by such critics of economics and economic reasoning as Gorz (1989) and Anderson (1990). Their definitions of economic goods would exclude contributed services.

Although a decision that all contributed services are revenue (and consequently "future economic benefits"), would lead to a perceived necessity to then recognize those services, there is no justification given for that decision. Failure to define the limits of financial accounting and the scope of the conceptual framework may lead to items which should not be there being brought into financial reports[7].

Contributed Services and Partial Recognition Criteria

As noted above, the FASB believes that the recognition criteria it has proposed will result in most contributed services not being recognized (FASB, 1993b, SFAS116, para 121). These recognition criteria are included in table 4.2. One of these criteria involves recognizing contributed services if they create or enhance non-financial assets. Non-financial assets are not defined. However, given the FASB's definition of contributed services as assets (FASB, 1993b, SFAS 116, para 5)[8], it seems reasonable to take from those recognition criteria the view that any time two volunteers help each other then each will be enhancing a non-financial asset (the asset provided by the other), and therefore the contributed services of both should be recognized. Recognition of contributed services will not be a rare event as the FASB assumes but a common one!

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[7]New Zealand's conceptual framework includes non-financial elements. For these to be effective, there will be a need to differentiate between those items which should be subjected to monetary measurement and those that should not.

[8] Assets are defined as probable future economic benefits (FASB, 1992a, SFAC6, para 25) "Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily - as the entity receives and uses them - although their use may create or add value to other assets of the entity" (FASB, 1992a, SFAC6, para 33). This view is similar to that of Paton (1922).

Contributed Services and Pre-existing Recommended Practice

The link between the final standard and pre-existing recommended practice is interesting:

> By drawing on existing industry guidance, the revised criteria should help minimize disruption to practice, yet also should improve practice by eliminating certain inconsistencies in the existing guidance. (FASB, 1993b, SFAS 116, para 120)

SOP 78-10, issued in 1978 to provide guidance over the period of development of a conceptual approach (see section 3.5), recommended the recognition of some contributed services[9].

The FASB's final position has been to use the conceptual framework to provide justification for the practice recommended in SOP 78-10. There does not appear to be any consideration whether such a practice is decision useful.

The FASB's decision process and justifications in respect of contributed services raises concern over the way in which the conceptual framework is used. A similar observation may be made in respect of the FASB's decision over accounting for pledges[10]. These practices warrant reiteration of a warning issued to the FASB:

> The Board and its staff must take the concepts seriously if they expect others to do so ... The Board's example of how to use the concepts will do more to enhance their stature and make them operational than any number of admonitions. Even more significant perhaps is that the Board's example must not abuse the concepts. (Storey, 1981, p5)

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[9]"The discussion draft [for SOP 78-10] stated that donated services should be reported as support and expense in certain limited circumstances. Recording of such services at all was new and resulted in considerable disagreement from a large and diverse group of nonprofit organizations. ... Unfortunately, even this restrictive approach was seen by many organizations in exactly the opposite way to what was intended" (Weinstein, 1978, p1015). Statements of Position were issued by the AICPA "for the general information of those interested in the subject. ... The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. ... statements of position do not establish standards enforceable under the Institute's code of professional ethics" (AICPA, 1981).

[10]An outline of the decision process is contained in: (FASB, 13.7.88; Bossio, 1991b; FASB, 1993b, SFAS116). When these judgements are compared with those used to justify contributions subject to conditions as a liability and contributions subject to restrictions as income the decisions made are quite inconsistent. They do, however, provide "conceptual" support for an existing accounting practice.

4.3.2 Revenue - Restricted Contributions

Nonprofit organizations commonly fundraise for projects before undertaking the expenditure (Cowperthwaite, 1991). Unlike profit-seeking organizations funding raised may be restricted for the particular purpose.

The definition of a liability and the interpretation of that definition resulted in the view that restricted contributions impose fiduciary duties but are not liabilities during the time that restrictions remain. The FASB determined that such contributions are restricted revenue (see section 3.7).

Despite earlier criticisms of fund accounting (Gross, 1975; Weinstein, 1978)[11], and views that it is unnecessary for general purpose external financial reports (Weinstein, 1978; Bossio, 1985; Seville, 1987; Anthony, 1989), the FASB's interpretation of restrictions follows a fund accounting concept[12] (Anthony, 1978; Seville, 1987). Table 4.3 compares the proposals of the surveyed countries for the recognition of restricted contributions.

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[11]The criticisms of fund accounting included confusion arising from a proliferation of financial statements produced as a result of establishing large numbers of funds (Gross, 1975) and that these funds could be used to obscure the information in financial reports (Weinstein, 1978).

[12]Those viewing fund accounting as unnecessary stated that decision usefulness is the role of financial reporting and not stewardship (Bossio, 1985), that fund accounting is primarily a budgetary device (Weinstein, 1978) and that user groups did not appear to rate the information content of fund accounting as important (Seville, 1987).

TABLE 4.3
Restricted Contributions

Country	Accounting Treatment
United States	Recognize as income and distinguish between permanently restricted, temporarily restricted and unrestricted. Differentiate restrictions from donor imposed conditions which allow income recognition only when conditions are met. A restriction expires when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. Recognize release of restrictions in period expired by reclassifying net assets, showing reclassifications separately from revenues, expenses, gains, losses. (SFAS 116)
Canada	Two possible approaches - one must be followed consistently (CICA, 1993) <u>Organizations Reporting on a Restricted Fund Accounting Basis</u> All restricted contributions to be recognized as revenue of the appropriate restricted fund in the period (para .239) Endowment contributions to be recognized as revenue of the endowment fund in the current period (para .237). Distinguish from unrestricted income and disclose major categories of restriction. Disclose types of external restrictions. <u>Organizations Not Reporting on a Restricted Fund Accounting Basis</u> Restricted contributions related to expenses of future periods deferred and recognized as revenue in the same periods as the related expenses are recognized (para .228) Endowment contributions are recognized as direct increases in net assets (para .224) Contributions restricted for the purchase of capital assets that will be amortized to be deferred and recognized as revenue on the same basis as the amortization expense related to the acquired capital asset is recognized (para .230) Contributions restricted for the purchase of capital assets that will not be amortized to be recognized as direct increases in net assets (para .231) (CICA, 1993; Danyluk, 1993)
United Kingdom	Recognize as income unless impossible to comply with restrictions, when liability "deferred restricted income" (CARC, 1993) Differentiate restrictions from conditions which allow income recognition only when conditions met (Framjee, 1993b) When donor imposed restrictions as to timing of related expenditure defer recognition of income to periods when it can be expended (Framjee, 1993b)
Australia	Recognize as income unless specific conditions exist <u>and</u> amount must be repaid, then liability recognised (SAC4)

In the United States the standard developed is in accordance with the FASB's determinations although a distinction has been drawn between restricted contributions, where the legal remedy is to seek performance of the services, and conditional contributions, where the donor has a right to the return of the funds in the event of failure to perform the services (Fetterman, 1990; FASB, SFAS116, 1993). Conditional contributions are to be recognized as a liability until the conditions are met, however, the difference between conditional and restricted contributions is likely to be difficult to determine in practice (Fetterman, 1990).

In the United Kingdom the first version of SORP2 (Accounting Standards Committee, 1988) allowed permanent endowment contributions to be direct increases in net assets and recommended a single columned income and expenditure statement which excluded endowment contributions. (A reconciliation and movement of funds was provided as a supplementary report). The later exposure draft of SORP2 (CARC, 1993) proposed that permanent endowment contributions be reported as income and recommended a multi-columned statement of financial activities showing unrestricted, restricted and endowment funds. Further revisions to that draft appear to be reinforcing the multi-columned fund accounting style of presentation[13].

In Canada fund accounting was originally suggested as an appropriate way to show the effect of restrictions (CICA, 1992, para .008; Hunt, 1992), but questions were raised as to how organizations, especially those not using fund accounting, would satisfactorily disclose restrictions and comply with the proposals of the exposure draft (Ernst & Young, 1992). Recently Canada developed two different methods of dealing with restrictions (Danyluk, 1993; CICA, 1993):

- one for fund accounting which follows that proposed by the FASB; and
- one providing for the non-use of fund accounting which proposes the matching of restricted contributions with related expenditure, endowment contributions as direct additions to net assets, and two different accounting

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[13]One modification relates to restricted contributions where the restrictions relate to a date when expenditure may occur. It is to be recommended that such contributions received be deferred (accounted for as if a liability) until the restricted date (Framjee, 1993b).

treatments for contributed fixed assets depending on whether they are to be amortized.

Canada clearly allows the choice as to whether fund accounting should be used and has compromised its conceptual framework in doing so[14]. The United Kingdom and the United States require either fund accounting or, as proposed in the United States, an adaptation of it.

While Anthony (1989) maintains that fund accounting is unnecessary, he is also a strong critic of the FASB's conceptual approach to nonprofit organizations and he supports the income/expenditure approach to the conceptual framework[15]. It appears to be such an approach that Canada has adopted for those organizations not using fund accounting.

The changes occurring in the United Kingdom and Canada favour the view that the conceptual approach to restrictions may be acceptable only with the presentation of a multi-columned fund accounting style of report.

4.3.3 Additions to and Distributions from Net Assets

The conceptual framework definitions require that direct additions to, or distributions from net assets may be made only by owners acting in their capacity as owners. Nonprofit organizations, defined as not having owners, are considered not to encounter such transactions.

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[14]As was observed in section 3.10 one of the reforms of the conceptual framework project was the asset/liability view (Miller, 1990). Canada's fund accounting method takes an asset/liability view while the alternative method appears to move back to the income/expenditure view.

[15]Anthony (1989) considered that "separate funds are necessary to distinguish the status and flow of contributed capital from the status and flow of operating items" (p89) but disagreed with the classifications of restrictions in SFAC6 because he thought temporarily restricted income should be treated as a liability. He would classify permanently restricted contributions as contributed capital.

Although contributions have been acknowledged to consist of an element of both capital and revenue (Hunt, 1992), the implications for nonprofit organizations are that a common practice in which 'capital' or non-operating receipts are added direct to net assets without first being reported in the income statement will cease. All such contributions will be required instead to be reported as revenue.

One justification given for this conceptual view was that the reported net surplus or deficit is not a measure of performance, and that distinguishing between capital and revenue would only be important if it were (Kerr, 1989). However, this conceptual view destroys the meaning previously attached to the reported surplus or deficit (Gross, 1975; Hyndman & Kirk, 1988; Anthony, 1989) (see section 3.12.1c).

There have been some modifications to the conceptual view that direct additions to net assets must come from owners. Endowment contributions were accepted as direct additions to net assets in the United Kingdom in the first SORP2 (Accounting Standards Committee, 1988), and in Canada for those organizations not using fund accounting (Danyluk, 1993; CICA, 1993) (see table 4.3). A further modification in Canada relates to some donated fixed assets for those not using fund accounting (Danyluk, 1993; CICA, 1993) (See table 4.3). The practical implications of the determination that all contributions are revenue arise in the presentation of financial reports.

4.3.4 Presentation of Financial Reports

The reported surplus or deficit of a nonprofit organization has been stated not to be a meaure of performance but observed to be considered as such (Gross, 1975; Hyndman & Kirk, 1988; Anthony, 1989) (see section 3.12). Kerr (1989) discussed an operations measure:

> If a concept of income more akin to operating income were adopted, some concept of contributed capital would be needed, and the problem of deciding between, say, grants

> that are revenue and grants that are to be considered capital contributions would then have to be faced. (Kerr, 1989, p60)

In Canada CICA (1993) proposes, for those organizations using fund accounting, a multi-columned statement of operations with a capital fund[16] as well as an endowment fund included in restricted funds. No entity totals are required. The net surplus or deficit on each fund appears to be proposed as an operations measure. For those organizations not using fund accounting a single columned statement of operations is proposed but specific contributions are omitted from it[17]. The reported surplus or deficit appears to be an operations measure (see appendix 3 for sample statements proposed).

The FASB had indicated a need for differentiating transactions related to operations from other transactions (FASB, 1992a, SFAC4, para 49), and considered highly important the issue of whether there should be a statement of operations or some measure of operations (FASB, 1992b; FASB, 1993c). However, it was found in trying to define an operations measure that agreement could not be reached (FASB, 1993c, SFAC117). Consequently the FASB decided to allow nonprofit organizations the discretion to determine an operations measure[18]. That measure may be reported in the statement of activities or in a separate operations report which is required to include the change in net assets figure, but apart from that the operating measure is unconstrained (FASB, 1993c, SFAS 117; Brown & Weiss, 1993) (see appendix 3 for sample statements proposed). The FASB does, however, refer to the operations measure as an

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[16]Anthony (1989) had proposed a capital fund using a double balance sheet in the style of Vatter (1947).

[17]Those contributions omitted are unspent restricted contributions, endowment contributions, contributions of fixed assets and of money restricted for the purchase of fixed assets.

[18]This is stated to be consistent with the discretion allowed to business organizations (FASB, 1993c, SFAS 117, para 67; Brown & Weiss, 1993).

intermediate one. Presumably a statement like that proposed in SORP2 (CARC, 1993) would not be acceptable.

One criticism of the FASB's decision to allow such leeway in determining an operations measure is that it is contrary to the reasons for the FASB's involvement in standard setting for the nonprofit sector; to enable a single set of principles to be developed[19] (Anthony, 1993).

A similar difficulty in developing an operations measure was acknowledged in the United Kingdom:

> After due consideration it became clear that distinctions based on operations tended to be arbitrary and were dependant on the impossible task of trying to match a charity's income and expenditure when clearly no such matching is possible or even desirable. Hence the Statement of Financial Activities tries to move away from giving undue emphasis to the bottom line based on matching, and focuses instead on the periodic measurement of the changes in the amounts and nature of the net resources of a charity. (Framjee, 1993d, p2)

SORP2 (CARC, 1993) has extended the statement of financial activities to include an analysis of net movements in resources shown as fixed asset increases or decreases, and other[20]. A similar style of statement had been proposed earlier on the basis that, " ... the distinction between revenue expenditure and fixed asset expenditure [is] academic to the realities of funding [the] requirement for cash" (Hillyer, 1987, p79). The SORP2 proposal has been criticized for including both capital and revenue expenditure (Lalvani, 1993), however, given the views expressed above by Hunt (1992) (see section 3.3) that contributions consist of an element of both capital and revenue, it appears that the United Kingdom has also

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[19] It is also contrary to the FASB's own view of the effects of requiring partial recognition of contributed services - the improvement of current practice by removing inconsistencies (FASB, 1993c, SFAS117, para 124).

[20] The form of this statement would provide, at least partially, for the views of Mautz (1989), Falk (1992) and Beechy & Zimmerman (1992) (see section 3.7.1). Fixed assets would be capitalized, but the presentation of the statement of financial activities would show, after the calculation of changes in net assets, the changes in nature of net resources including expenditure on fixed assets.

been contending with an effect of the definitions in the conceptual framework. The previous meaning of the net surplus or deficit is no longer valid and the new meaning may not be a measure of performance but could be perceived as such.

SFAC4: *Objectives of Financial Reporting of Nonbusiness Organizations* and the comments made at the time of issue of SFAC6: *Elements of Financial Statements* require reconsideration (see section 3.6 for a fuller discussion). The reporting objectives of nonprofit organizations were stated to be different from those of business because the needs of external users were different. The important information for users was stated to be (Bossio, 1985, p4):

- business financial reports: "earnings, comprehensive income and their components";
- nonprofit organization financial reports: "the nature of and relation between inflows and outflows of resources";
- both sets of reports: "information about economic resources, obligations, net resources and changes in net assets".

SFAC4 states some of the information considered to meet the requirements for users of financial reports of nonprofit organizations:

> Financial reporting should provide information about the amounts and kinds of inflows and outflows of resources during a period. It should distinguish resource flows that change net resources, such as inflows of fees or contributions and outflows for wages and salaries, from those that do not change net resources, such as borrowings or purchases of buildings. It also should identify inflows and outflows of restricted resources. (FASB, 1992a, SFAC4, para 48)

The reference to inflows and outflows of resources is, like restrictions, a fund accounting concept (Herzlinger & Nitterhouse, 1994, p193-200). Vatter (1947) expressed concern about the level of layperson understanding of a measurement of income. He presented instead a statement of all inflows and outflows (see appendix 1). SFAC4 acknowledged varying levels of user understanding and that the understandability of information provided may need to be improved (FASB, 1992a, SFAC4, para 37).

The FASB's proposed statement of activities focuses on changes in net assets. This is different from the inflows and outflows of resources referred to in SFAC4 (above). Although the proposed statement identifies restricted income, it does not identify those resource outflows that do not change net assets. A reason for this is given in SFAS117: *Financial Statements of Not-for-Profit Organizations* which states that "a single statement of 'funds flows' might unnecessarily confuse items of revenue ... with expenditures to acquire non-current assets" (para 46). It is to be noted that this reason refers neither to users nor to decision usefulness[21].

Framjee's (1993d) justification for the SORP2 (CARC, 1993) proposed statement of financial activities requires thought:

> In many cases it is not possible to arrive at a meaningful bottom line and therefore the excess of income over expenditure for the financial year can often be misleading. Whilst it may be believed that a bottom line surplus or deficit could provide information showing the extent to which the charity can fund ongoing expenditure out of current income, any presentation that arrives at such a bottom line for the year ignores a fundamental difference between accounting for charities and commercial organizations. ... Furthermore, the traditional income and expenditure account with the historical distinction between revenue and capital does not fully explain a charity's activity. In certain years a charity may use general income to support capital expenditure and since this expenditure will not be shown in the income and expenditure account it might appear that it has a surplus when in fact it has spent the money on fixed assets which may be as important to its mission as is the other revenue expenditure shown in the income and expenditure account. ... In recognition that charities do not generally have any one single indicator of performance comparable to a business enterprise bottom line it is perhaps more important to consider the changes in the amounts and nature of the net resources of a charity. ... Accordingly, the SORP recommends a primary statement that records all the resources entrusted to the charity and reflects all the financial activities in the period under review. (Framjee, 1993, p2)

[21]SFAC4 acknowledged the importance of resource providers to nonprofit organizations (para 36), that users of financial information of nonprofit organizations had varying levels of understanding of that information, and that financial reporting would be of little use to those unable to use it. It was acknowledged that efforts to increase the understandability of financial information may be necessary and noted that " financial reporting should not exclude relevant information merely because it is difficult for some to understand or because some choose not to use it" (para 37). "Thus, resource providers tend to direct their interest to information about the organization's resources and how it acquires and uses resources" (para 39).

4.3.5 Net Assets

The concepts developed for the nonprofit sector reflect the view that financial reports should present totals for the entity and not merely consist of a succession of funds statements.

The FASB divided the element 'net assets' into three classes; unrestricted, temporarily restricted and permanently restricted. It requires disclosure of all three classes, and reporting the total of those three classes. CICA (1993) and SORP2 (CARC, 1993) do not adopt the FASB's reclassifications, but do adopt the requirement to present totals. SORP2 requires the total of funds to be shown (CARC, 1993, p54), and CICA (1993) requires the net assets section to show "... the portions of net assets attributable to endowments, to capital assets and to other external and internal restrictions, none of which can be readily reallocated for other purposes (CICA, 1993, para .108)[22].

All countries have in common a requirement for entity totals. The implications for those organizations using fund accounting are that they will be required to present those totals with funds grouped according to the nature or level of restrictions. Further analysis would be required to meet the Canadian requirements. Those not using fund accounting will need to keep some record of all restrictions in order to report on the whole entity and at the same time disclose those restrictions. These requirements may encourage such organizations to adopt fund accounting.

[22]Unlike the FASB (1993) and SORP2 (1993), CICA (1993) does not require those organizations using fund accounting to present totals for the whole entity in the statement of operations and changes in net assets (CICA, 1993, para .116).

4.3.6 Reporting Entity

The reporting entity concept, adopted in Australia, the United Kingdom and New Zealand, has two aspects to it:

- defining those entities required to produce general purpose financial reports; and
- defining the boundaries of the reporting entity using the concept of control.

General Purpose Financial Reports

The reporting entity concept is user oriented, requiring the preparation of general purpose external financial reports if dependent users exist. Dependent users are users reliant on general purpose financial reports for their information.

The publicly oriented nature of many charities is such that under the reporting entity concept even very small organizations are likely to have dependent users and so be classed as reporting entities. This implies a requirement to produce general purpose external financial reports and may be expensive for small charities.

Questions related to size have been raised in Canada[23] (Ernst & Young, 1992), while in the United Kingdom SORP2 (CARC, 1993) considers size relevant in deciding which charities must produce general purpose external financial reports. It identifies small charities as those having gross receipts of less than £25,000 and requires such small charities to produce a summary of receipts and payments together with a statement of assets and liabilities, instead of the full general purpose external financial reports (CARC, 1993, p8).

[23] Canada proposes that those organizations with average total annual revenues of less than $250,000 over two years need not capitalize fixed assets in the manner laid out in the exposure draft provided that the board of directors of that organization have agreed to that policy (CICA, 1993, paras .302, .336).

Unless size is taken into consideration all charities, including the very small ones, may be required to produce general purpose external financial reports, such a requirement being likely to impose disproportionate costs on very small organizations.

Controlled Organizations

The reporting entity concept defines the boundaries of an organization by considering the presence or absence of control over other organizations. The definition of control as specified in Australia's SAC1: *Definition of the Reporting Entity* indicates that control enabling the achievement of the objectives of the reporting entity is sufficient to require that such controlled entities are a part of one economic entity. There is no requirement that the objectives be economic objectives or that the controlling entity have the ability to "deploy ... resources and enjoy the benefits of that deployment" (Ball, 1988, px). The reporting entity consists of the focal entity and all other entities it controls which may themselves also be reporting entities (see section 3.12.2).

The principle of control has been developing as a way of establishing the identity of subsidiary organizations, but where there is no ownership interest there has been relatively little development in accounting standards. Tables 4.4 and 4.5 compare the definitions of control and criteria for determining its existence.

TABLE 4.4
Controlled Entities

Country	Criteria to Define Control
United States	Current project on agenda Acknowledges concept of control (FASB, 1991)
Canada	CICA (1993) Control: continuing power to determine strategic operating, investing and financing policies without the co-operation of others (para .502). Economic beneficial interest exists if the other organization holds resources that must be used for the unrestricted or restricted purposes of the reporting organization. Resources of the other organization are considered to be for the use of the reporting organization when they either will flow to the reporting organization or will be used to produce revenue or provide services for the reporting organization. Economic beneficial interests exist in situations such as the following: (i) The other organization solicits funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor, or are otherwise required, to be transferred to the reporting organization or used at its discretion or direction; (ii) The reporting organization transfers resources to the other organization whose resources are held for the benefit of the reporting organization; or (iii) The other organization performs functions on behalf of the reporting organization that help the reporting organization fulfill its purpose (para .502).
Australia	Control - "capacity ... to dominate decision making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity" (para 13). (AARF, AAS24 Consolidated Financial Reports).
United Kingdom	Control: - The ability of an undertaking to direct the financial and operating policies of another undertaking with a view to gaining economic benefits from its activities. (FRS1, para 6) Branches that are not separate legal entities are considered to be controlled (CARC, 1993, para 41). Where control is exercised by the parent charity ... consolidated accounts should be prepared in appropriate cases as set out in the Financial Reporting Standard (CARC, 1993, para).

The definition of control used in the United Kingdom refers to specific reasons for having control of a subsidiary organization; to gain economic benefits. Like the Australian definition the Canadian one does not refer to such a reason. Canada, however, separately defines economic beneficial interest.

TABLE 4.5
Controlled Entities

Country	Criteria to Determine Existence of Control
United States	Current Project on Agenda
Canada	CICA (1993) Control presumed when right to appoint the majority of members of board, otherwise presumed no control (para .504) Presumption may be overcome by other factors. Economic beneficial interest is an important characteristic in determining whether control exists in the absence of a right to appoint board members. The significance of the economic beneficial interest can vary. For example, if an organization is only able to raise funds and transfer them exclusively to the reporting organization, the economic beneficial interest is so significant that the reporting organization may exercise control over the other organization even without the ability to appoint the majority of the other organization's directors. A less significant economic beneficial interest would have less impact on the presumption regarding control. Another important characteristic is the reporting organization's level of responsibility or accountability for the other organization's activities. ... eg responsibility to cover deficits or liabilities. It may be concluded that control exists, despite the fact that the reporting organization appoints less than the majority of the board of directors (para .506).
Australia	AARF, AAS 24 Consolidated Financial Reports The definition of control depends upon substance rather than form and, accordingly, determination of the existence of control will involve ... judgement (para 21). Any of the following factors would normally indicate the existence of control ... (a) the capacity to dominate the composition of the board ...; (b) the capacity to appoint or remove all or a majority of the directors ...; (c) the capacity to control the casting of a majority of the votes ... of the board ...; (d) the capacity to cast, or regulate the casting of, a majority of the votes ... at a general meeting ...; (e) the existence of a statute, agreement, or trust deed, or any other scheme, arrangement or device, which ... gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity ... (para 22). The capacity ... to dominate decision-making, in relation to the financial and operating policies of another entity, is insufficient in itself to ensure the existence of control ... . The parent entity needs to be able to dominate decision-making so as to enable that other entity to operate with it as part of an economic entity in pursuing its objectives (para 30).
United Kingdom	CARC (1993) If not separate legal entity (para 40). If using name of parent charity and/or registration number. (In this case activities are on behalf of parent charity) (para 41). Special trusts as defined s1 Charities Act (1992) (para 42). (note exemptions and exceptions from supervision by Charity Commission section 4.4.1)

In Canada and Australia, although the definitions of control exclude any reference to an economic beneficial interest, they do refer to such an interest in the criteria used for determining the existence of control. In Canada, if there is no ability to appoint the majority of members of the board, the presumption made is that there is no control unless the significance of the economic beneficial interest or level of the reporting organization's responsibility for the other entity is such that the presumption is overcome.

In Australia an arrangement enabling the reporting organization to "enjoy the majority of benefits and to be exposed to the majority of the risks of that entity" (para 22) is an indicator of control.

Although Australia adopted its reporting entity concept, and its standards relate to "each private sector reporting entity" (AARF, AAS24) the indications of control in its standards are different from the criteria proposed for nonprofit and government organizations by Ball (1988) and from the similar criteria included in its concepts statement (see section 3.12.2). It is not clear whether Ball's work and the criteria proposed in the concepts statement have been dismissed or overlooked.

Holder, like Ball (1988), preferred a concept of control for determining the reporting entity[24]:

> One of the units must possess authority over the second to: (a) select the governing authority, or (b) designate management, and (c) influence significantly or control the operations. Additionally, financial interdependency should normally exist between the two units and the dominant unit should usually be accountable for fiscal matters. (Holder, 1986, p6)

The criteria proposed by Holder (1986) and Ball (1988) are similar, but Holder's require the selection of the governing authority/management *and* influence or

[24]The FASB commissioned Holder's study into the nonprofit sector in 1983. Anthony's 1978 study had excluded the reporting entity from consideration.

control over operations, while Ball's criteria are referred to as a "set, in that control is assessed after considering all the elements" (Ball, 1988, p60).

Concerns about fragmentation of nonprofit organizations and inclusion of the subject on the FASB agenda (Bigalke, 1990; FASB, 1991) indicates the likelihood that further attention will be paid to this matter, and that further changes to accounting standards may be made.

Developments to the indications of control may result in requirements for very fragmented organizations to produce consolidated financial reports which would be expensive as well as technically difficult. Only SORP2 (CARC, 1993) and (ASC, 1988) has addressed the major costs likely to be incurred by such fragmented organizations required to produce consolidated financial reports. It proposes that only large groups should do so, large groups being defined as those qualifying under any two of the following criteria (CARC, 1993, para 46):

- gross resources (includes intra group transactions) arising in the year exceeding £13,440,000 or net resources exceeding £11,200,000;
- gross (including intra group balances) aggregate Balance Sheet total of £6,720,000; or £5,600,000 net Balance Sheet total;
- group employment of more than 250 persons.

4.4 REGULATION OF CHARITIES

It has been recognized that charities form a significant segment of the community which handles large amounts of money[25]. Charities receive a number of financial benefits and concessions. These include tax incentives for donors to contribute to charities, exemption from income tax, and exemptions or relief in

[25]In the United Kingdom in 1990 there were 170,000 registered charities raising 17 billion pounds (Prescott, 1992), while in the United States contributions to charities were $122.7 billion of which 83% was contributed by individuals (Harvard Law Review, 1992).

respect of other taxes or rates (St. Leon, 1990; Driscoll, 1992; Harvard Law Review, 1992; Davis, 1993).

There are two methods of regulating the behaviour of charities:

- by governmental regulation; and
- by self-regulatory bodies setting standards to be observed.

4.4.1 Governmental Regulation

Generally there is some supervision undertaken by governmental bodies to establish entitlements to tax concessions, to ensure that the charitable purposes for which entitlements have been granted are carried out and that fundraising practices are within the law.

In Canada and the United States the tax authority registers charities as tax exempt and has specific requirements for annual returns to be filed and examined (Harvard Law Review, 1992; Inose, 1993; Davis, 1993). In both cases the tax authority has the power to revoke the tax free status[26].

In addition states may set laws regulating charities. As an example New York is considered a leading state in developing laws in relation to charitable fundraising and in 1987 adopted *A Model Act Concerning the Solicitation of Funds for Charitable Purposes* (Harvard Law Review, 1992). This act requires the registration of any charitable organization intending to solicit contributions. It also requires the prompt filing of annual reports and an annual return.

- Failure to file the required information on time will lead to cancellation of registration;
- Fund-raisers must be registered and file a bond;

[26] In the United States the tax free status of the United Cancer Council was revoked after it raised $8 million through a direct mail appeal and paid 95% of the funds raised to a fund raising organization (Harvard Law Review, 1992).

- Fund raisers must have a written contract with a charity and this must contain details of the financial arrangements between the fundraiser and the charity;
- A copy of the contract must be filed, acknowledged, and have been on file for at least fifteen days before any fund raising services may commence (Dropkin et al, 1988).

Generally accepted accounting principles are to be observed when preparing financial reports:

- If turnover is less than $75,000 financial reports are not required to be audited;
- If turnover is between $75,000 and $150,000 an independent chartered public accountant's review is required;
- If turnover is more than $150,000 or any of those fundraising for the organization were paid for their services an opinion from a public accountant that the financial reports present fairly the organization's operations and financial position is required (Dropkin et al, 1988).

In Australia also, the states may set laws regulating charities. New South Wales issued the Charitable Fundraising Act 1991 and this requires those carrying out fundraising appeals to:

- be authorized to conduct such appeals (s.9);
- follow specified procedures in handling funds raised (s6);
- file audited statements of the gross and net amounts (after expenses) from each appeal, and the application of the proceeds (s23);
- provide audited financial statements to any person requesting them (s47).

In addition, the auditor is required to report any contravention of the Act, or any other matters not able to be adequately dealt with in the audit report to the Minister (s24), and the act provides powers of revocation of authority, investigation, and the ability to appoint an administrator under particular circumstances (s33).

In the United Kingdom charities are supervised by the Charity Commission which is empowered by the Charities Act 1992 to ensure the accountability of charities (Jackson, 1991).

The Act

- allows the Charity Commission to supervise and investigate charities;
- establishes new controls over fundraising, requiring a written contract between a charity and a professional fund raiser, and the fundraiser to make clear the terms of the contract to prospective donors (Driscoll & Phelps, 1992); and
- regulates public charitable collections (Prescott, 1992)

The Act has also established differential requirements for the production and filing of financial reports[27]:

- If turnover is less than £1,000, charities need not produce financial reports (such charities would be unregistered (Derwent, 1992));
- If turnover is less than £25,000, charities may produce a receipts and payments account and statement of assets and liabilities;
- If turnover is less than £100,000, charities may choose to have an independent examiner (someone considered competent) instead of an auditor;
- If turnover is greater than £100,000, financial reports must be audited;
- Financial reports must be filed with Charity commission within ten months of financial year end (Bose, 1992) together with a trustees report of the activities of the charity for the year and an annual return (Driscoll & Phelps, 1992).

The Charity Accounting Review Committee (CARC) has promulgated the latest exposure draft of SORP2 and it appears that this body is taking an accounting standard setting role.

4.4.2 Self Regulation

In addition to government regulation of charities, community supervisory groups exist and these may be self-regulatory groups, establishing ethical standards

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[27]There are exemptions and exceptions from the Charity Act. Exemptions include Church Commissioners (and any institution administered by them); exceptions from registration include "certain church charities, ... charities registered under the Places of Worship Registration Act 1955 and charities that neither have permanent endowment nor the use or occupation of land nor income from property exceeding 15 pounds" (Driscoll & Phelps, 1992, p9).

and practices for members to observe, or advisory groups providing information about the activities of charities for the benefit of prospective donors. Membership of the self regulatory groups, or compliance with the standards set by the advisory groups is considered to be well-regarded by charities, being seen as providing distinction in promoting the organization when fundraising (Ference, 1989).

Self-regulatory groups vary but typical examples of such groups in the United States include the Evangelical Council for Financial Accountability and the Council of Better Business Bureaus. Both of these organizations have published standards to be met by their members in relation to public accountability and ethical practices (Council of Better Business Bureaus, 1982; Abelman, 1989). In the United Kingdom such groups include the National Council for Voluntary Organizations and the Institute of Charity Fundraising Managers (Driscoll & Phelps, 1992).

Advisory groups evaluate the financial reports of charities, making data available on request, providing reports on individual organizations, and publishing guides[28] (Ference, 1989; National Charities Information Bureau, 1991). These organizations publish standards that they consider charities should meet, judging charities based on those standards[29].

These regulatory processes, both governmental and voluntary, help to determine the content and style of financial reports, and the level of auditing required. With exceptions for small organizations, financial reporting requirements tend to be that

[28] An example of such a guide is the Wise Giving Guide published by the National Charities Information Bureau which evaluates and reports on more than 400 charities (NCIB, 1989).

[29] In respect of annual financial reports the NCIB has determined that an annual report should be available on request and should include: "an explicit narrative description of the organization's major activities, presented in the same major categories and covering the same fiscal period as the audited financial statements; a list of board members; audited financial statements ..." (NCIB, 1991, p15).

generally accepted accounting principles be observed and that financial reports be audited.

4.5 AUDITING OF CHARITIES

> The standards of work required of a professional person are not lowered because he is doing a job for little or no fee; it would not be beneficial to anyone if they were. (Bird & Morgan-Jones, 1981, p213)

Charities commonly issue audited financial statements but concern has been expressed that accounting standards are frequently breached and yet the financial statements still carry an unqualified audit opinion (Bird & Morgan-Jones, 1981; Falk, 1981; Figlewicz et al, 1985). Possible reasons given for this have included a view that auditing charities is a community service with only small legal risk and inadequate fees (Figlewicz et al, 1985), so charity audits have been allocated around partners in accounting firms (Bose, 1992), the lowest paid staff used (Radich, 1992) and problems avoided (Bird & Morgan-Jones, 1981).

In stating the requirements to be met in the audit report of a charity Bird & Morgan-Jones (1981) commented that had they not carried out a survey of charity financial reports they would have thought some of the matters they raised to be "too obvious to need mentioning" (p214). They called for guidance on auditing charities and the United Kingdom now includes such a guideline in its members' handbook. Audit guides concentrating on the peculiarities of charities and nonprofit organizations have also been issued in the United States[30] and Canada[31] and one is currently being prepared in Australia (Radich, 1992).

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[30]The American Institute of Chartered Public Accountants has issued three audit guides: *Audits of Certain Nonprofit Organizations*, 1987; *Audits of Voluntary Health and Welfare Organizations*, 1988 and *Audits of Providers of Health Care Services*, 1990.

[31]*Audits of Non-profit Organizations*, 1993, Canadian Institute of Chartered Accountants.

4.6 SUMMARY

Increased efforts to internationalize accounting standards derive from the globalization of financial markets with the beneficiaries of these efforts considered to be multinational businesses. Although increasing globalization of nonprofit organizations is predicted the nonprofit sector is excluded from the conceptual framework and standard setting of the IASC but included in those of all of the individual countries surveyed.

Full internationalization of accounting standards is expected to be a long process because of individual differences between countries. The strategy adopted is for countries to work both to harmonize their standards with those of the international body and with one or more other countries. An example of this strategy may be seen with the agreement between Australia and New Zealand, but if special aspects of the nonprofit sector are overlooked in the setting of domestic standards such an oversight will not be alleviated by the internationalization commitments.

Implications of the conceptual framework developments are seen in accounting standards developing which apply the definitions of elements of financial reports.

Those setting accounting standards claim a conceptual approach in the absence of evidence that such an approach should not be taken. Tracing the FASB standard setting process for contributed services leads to some doubt over this on occasions. Although the conceptual framework was used to justify the final accounting procedures chosen, it appeared not to be used in determining whether all contributed services do constitute revenue while the decision usefulness focus of the conceptual framework was ignored.

Anthony (1978) had identified two major differences between nonprofit organizations and businesses; restrictions and contributions of 'capital'. These differences were dealt with by the FASB by adopting a fund accounting concept of restrictions and by defining direct additions to net assets in such a way that all contributions received by a nonprofit organization are required to be reported as income. In the United States fund accounting has been adapted and this involves recognizing restricted income in a multi-columned statement, then reclassifying net assets when restrictions are met.

In Canada there has been some wavering between the conceptual approach for which fund accounting was proposed and an alternative approach not requiring fund accounting. The alternatives recently proposed in Canada are at odds with the conceptual view, moving away from the asset/liability approach to the conceptual framework and back to the income/expenditure approach. This appears to indicate that the conceptual approach to restrictions will be appropriate only when fund accounting, or an adaptation of it, is practised. In the United Kingdom the single columned statement proposed in the first SORP2 (ASC, 1988) has been rejected and a multi-columned fund accounting style presentation proposed. There has clearly been a level of unacceptability of these standards with SORP2 (CARC, 1993) re-exposed after only five years, and both the FASB and CICA having to re-expose their proposals for the nonprofit sector.

Commentary in SFAC4 proposes that the inflows and outflows of resources is an important focus for users of financial reports of nonprofit organizations but the FASB has dismissed such information as likely to be confusing and focuses its statement of activities on changes in net assets. Consequently this will not show the inflows and outflows of resources because outflows on items that do not change net assets are not shown. Of the various proposals for presentation of financial reports that proposed in SORP2 (CARC, 1993) appears the most promising because it does concentrate on providing the information acknowledged as being required.

Australia's reporting entity concept has been adopted in New Zealand and the United Kingdom, but the indications of control developed as being applicable for organizations other than companies appear to have been either dismissed or overlooked. As observed in chapter 3 the implications of the reporting entity concept are that even very small nonprofit organizations are likely to be considered reporting entities and the concept of control could well lead to massive consolidations for those very fragmented organizations. SORP2 (CARC, 1993) has proposed differential criteria for applying accounting standards and these will be of assistance to very small organizations and to larger fragmented ones. Unless such criteria are developed disproportionate expenses are likely to be incurred if accounting standards are to be complied with.

Self regulatory and consumer watchdog groups provide some monitoring of charities but in return for tax concessions charities, and their fundraising practices, are also subjected to governmental supervision. Most of the regulatory bodies impose a requirement for auditing but there have been findings that unqualified audit reports are issued despite lack of compliance with accounting standards. Audit guides are available in the United States, Canada and the United Kingdom, and one is being developed in Australia.

CHAPTER 5

CHARITIES IN NEW ZEALAND

5.1 INTRODUCTION

The comparability of conceptual framework projects and commitments to internationalize accounting standards means that standards promulgated in New Zealand are likely to be similar to those developed overseas. New Zealand has undertaken to harmonize its accounting standards with Australia, and both Australia and New Zealand are committed to harmonizing their standards with those of the International Accounting Standards Committee (Porter, 1991). Although Australia and New Zealand include the nonprofit sector in their conceptual frameworks, the IASC excludes it. If the nonprofit sector is overlooked in setting domestic standards, harmonization with international standards cannot be expected to remedy such an oversight.

This chapter observes that the economic factors affecting charities in New Zealand are similar to those overseas. It then examines the standard setting process in New Zealand, and the application of New Zealand's accounting standards to the nonprofit sector. Chapters 3 and 4 identified implications for the nonprofit sector as a result of the conceptual framework projects and the development of accounting standards. These are reviewed and examined in relation to New Zealand's issued exposure drafts and standards. The concessions granted to charities and New Zealand's regulatory environment is considered as is the auditing of financial reports.

5.2 ECONOMIC FACTORS AFFECTING CHARITIES IN NEW ZEALAND

In New Zealand, as overseas, the nonprofit sector has been funded by the government to provide welfare services on its behalf (Nixon & Levett, 1988). The international trend towards new public management can also be identified in New Zealand (Fraser & Wilson, 1988; Hood, 1991; Dell, 1992) and was considered to have "unusual coherence" here (Hood, 1991, p6), although for political reasons there was some reluctance to make reductions in the social welfare system (Fraser & Wilson, 1988).

Unlike the United Kingdom, remixing of the economy was not proposed but "devolution"[1] was (Durie, 1988; Bushnell & Scott, 1988; Palmer, 1988), with "accountability considered inseparable from devolution" (Bushnell & Scott, 1988, p21). The political origins of this devolution were traced to a combination of concerns about poor economic performance and a view that the government bureaucracy had become too large[2] (Palmer, 1988).

Cuts to the funding of nonprofit organizations and increasing requirements for services provided by them have been observed (Rivers, 1992). Currently, health and welfare service provision is changing to a formal contractual basis with competition for service provision using a tendering process (Upton, 1991). The

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[1] "Devolution ... is defined as the delegation of portions or details of duties to subordinate officers or committees, and to devolve therefore is to delegate to deputies duties for which the principal remains responsible. Recently in New Zealand, the term has been used to mean 'the development of local answers to local problems' ... This idea has been taken further to mean 'partnership' between central government and local groups or 'power sharing'. With common usage, therefore, the term devolution has come to mean a particular form of delegation from central government. While the ultimate responsibility for outcomes remains with the government, it delegates a process to be followed when decisions are made at a local level" (Bushnell & Scott, 1988, p19).

[2] Some agreement with this view was acknowledged by the Royal Commission on Social Policy which observed both support and concern about devolution although "clear indications of interest in a move to participatory democracy" (Durie, 1988, p38) had been received.

most recent change to this method of service provision occurred on 1 July 1993 with the establishment of Regional Health Authorities as purchasing authorities for health services (Bowie, 1993).

As has occurred overseas, reductions in government welfare provision and consequent increasing demands on the nonprofit sector may also lead to an expansion of the sector and calls for an improvement in general accountability.

5.3 THE STANDARD SETTING PROCESS IN NEW ZEALAND

The process of setting accounting standards in New Zealand is currently carried out by the New Zealand Society of Accountants. The council of the society delegates responsibility for standard setting to the Financial Reporting Standards Board. This board has twelve members and a structure intended to constitute a cross-section of those affected by accounting standards (Porter, 1991). The Financial Reporting Standards Board has four committees of which two are financial reporting committees (Simpkins, 1993).

The terms of reference of the Financial Reporting Committees include keeping matters of accounting theory and practice under review. There are also specific requirements in relation to observation of standard setting and research in other countries but these refer only to Australia and the IASC (NZSA-FRSB, 1993). Because international standards exclude the nonprofit sector, these terms of reference imply reliance on Australia for consideration of the nonprofit sector.

In developing standards, however, proposed exposure drafts submitted to the board must be accompanied by a comparison with overseas standards (NZSA-FRSB, 1993, p10), and proposed final drafts submitted must also be supported by additional documentation including "a summary of any significant variations in the statement from statements on similar subjects issued by accounting bodies in

Australia, Canada, United Kingdom and United States of America" (NZSA-FRSB, 1993, p11).

Although New Zealand's conceptual framework and accounting standards apply to all reporting entities, concern has been expressed at the dominance of large chartered accounting firms and corporations in the standard setting process, and the general lack of participation by others (Porter, 1991). Representatives of these organizations dominate, both at board level (Porter, 1991; Simpkins, 1993) and in responding to exposure drafts (Porter, 1991).

The greatest opportunity for participation in the standard setting process is in responding to exposure drafts, but Porter (1991) observed that despite a circulation of some 13,200 for exposure drafts, in 1989 and 1990 the largest number of responses to any exposure draft was 47 and she considered this to be in response to seminars she had presented explaining the standard setting process. The eleven exposure drafts issued in those two years brought an average of eleven responses each. This lack of participation in the decision process has also been cited as a concern in the United States (Wyatt, 1991).

5.4 ACCOUNTING STANDARDS

Currently in New Zealand all accounting standards apply to charities except for two[3]. Dixon & Rees (1984) had noted lack of clarity in specifying the entities some standards applied to. They also recommended an accounting standard especially for nonprofit organizations, giving examples of matters that could be included

[3]SSAP9 *Information to be Disclosed in Company Balance Sheets and Profit and Loss Accounts*, and SSAP20 *Accounting for Shares Issued Under a Dividend Election Plan*. In 1992 an exposure draft was issued, ED 67: *FRS-9: Information to be Disclosed in Financial Statements - A Revision of SSAP9* and this is to be applied to all organizations, including charities.

(p61)[4], but noted that 79% of the auditors they surveyed did not consider such a standard necessary (p.59). The applicability of accounting standards was later clarified but no special standard was developed.

The nonprofit sector appeared not to be considered again until 1993 when ED-70 *Accounting for Grants and Donations* was issued. This exposure draft is the first in New Zealand seeking to apply the conceptual framework and, in addition to covering matters especially affecting the nonprofit sector, is an example of the effect the conceptual framework is expected to have on accounting standards (NZSA, 1993b, discussion paper). Unlike the standard setting bodies in the United States, Canada and the United Kingdom the New Zealand Society of Accountants is not developing a special standard for the nonprofit sector. Instead it is attempting to apply its standards to all sectors, including the government sector.

The proposals in ED-70 cover some of those matters identified in chapters 3 and 4 as having implications for charities, specifically the definition of revenue, including contributed services and restricted contributions, additions to/distributions from net assets, and net assets. These proposals have similarities to documents issued in Canada (CICA, 1992), the United States (FASB, 1993b, SFAS116), and the United Kingdom (ASC, 1988; CARC, 1993). The general guidance of Australia's concepts statement SAC4 *Definition and Recognition of the Elements of Financial Statements* is noted[5] and significant differences between

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[4]Inclusive v exclusive treatment of income and expenses in the financial statements; allocation of overheads between functional activities; asset valuation bases - particularly fixed assets and investments; depreciation of fixed assets; accounting treatment of legacies, restricted and unrestricted funds, donated assets and services.

[5]In Australia no standard or exposure draft has been issued. SAC4 contained an appendix applying some of its definitions to the nonprofit sector. At the time SAC4 was issued it was intended that concepts statements have the effect of standards if there are no other applicable standards but that status was removed in May 1993. It will be necessary for Australia to eventually issue a standard.

ED-70 and the international standard are acknowledged (NZSA, 1993b, Appendix 2).

5.4.1 Revenue - Contributed Services

New Zealand's conceptual definition of revenue, like that in the other conceptual frameworks, is not confined to monetary items, and ED-70 includes contributed services in the definition of grants:

> Non-reciprocal transfers by an entity (donor) to another entity (donee) except where the transfer is a contribution by owners or a distribution to owners. Grants may take the form of cash, services, transfer of an asset or reduction of an existing liability. Conditions may or may not attach to the grant. (NZSA, 1993b, para 4.2)

ED-70 proposes that the value of contributed services be recognized by the donee at fair value (para 6.3):

- when a fair value can be reliably estimated, and
- when the services are normally purchased by the entity, and
- when the services would be paid for if not donated.

These recognition criteria are essentially the same as those proposed in Canada (CICA, 1992; CICA, 1993), however, Canada allows the option to recognize contributed services while New Zealand, like the FASB (FASB, 1993b, SFAS116), requires recognition (see section 4.3.1).

The FASB considers its treatment of contributed services to have improved current practice by removing inconsistencies (FASB, 1993b, SFAS116, para 124). Dixon & Rees (1984) in their survey of nonprofit organizations noted that very few commented on donations other than in cash. Only one organization had equated contributed services to the costs saved if employees had carried out those services and this information was provided in note form (Dixon & Rees, 1984, p42). Unlike the United States, New Zealand has not had accounting guides recommending either partial or full recognition of contributed services so the proposal for partial recognition in ED-70 will not remove inconsistencies.

The FASB has claimed, but not demonstrated, that requiring partial recognition of contributed services is "clearly relevant" (FASB, 1993b, SFAS 116, para 120), and decision useful despite lack of support for that contention (Adams, Bossio & Rohan, 1989) and warnings that partial recognition is likely to be misleading (Anthony, 1978; Booth & Paterson, 1982). Given doubt about the FASB's claims of decision usefulness and relevance in respect of partial recognition of contributed services, it is appropriate that such doubts should also be voiced in New Zealand. ED-70 gives no indication of how decision usefulness has been established in New Zealand or of the manner in which the proposed requirement is deemed to meet the qualitative characteristics of the conceptual framework: relevance, understandability, reliability and comparability. The discussion paper accompanying the exposure draft instead requests indications of whether the recognition of contributed services is considered appropriate (NZSA, 1993b, ED-70 discussion paper).

5.4.2 Revenue - Restricted Contributions

ED-70 defines restricted grants as:

> Grants subject to specific conditions accepted as binding by the donee, which may not be revised by the donee without reference to the donor or a third party. (NZSA, 1993b, para 4.10)

ED-70 then specifies that:

> Restricted grants shall be separately disclosed by the donee as revenue or as a liability with appropriate note disclosure of the conditions applicable and any changes in conditions that may have occurred in the current period. (NZSA, 1993b, para 6.7)

In deciding whether a liability exists ED-70 requires the donee to consider the definition and recognition criteria of a liability[6] and the nature of the conditions not met (NZSA, 1993b, para 6.8).

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[6]"Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. The definition of liabilities identifies three essential characteristics: (a) there must be a present obligation, that is, the entity must have a duty or responsibility, which has not yet been satisfied, to act or perform in a certain way; and (b) there must be

As to whether restrictions are or are not liabilities New Zealand's exposure draft is less specific than those documents issued in the United States, Canada, Australia and the United Kingdom (see section 4.3.2). It gives the impression of acceptance that restrictions may constitute liabilities.

However, ED-70 proposed recognition criteria for donors[7] that differ from those for donees and these recognition criteria are closer to the views proposed in the other countries that restricted contributions impose a fiduciary responsibility but not a liability. This inconsistency has already caused some concern[8].

ED-70 does not differentiate between temporary and permanent restrictions, but concentrates only on restricted and unrestricted grants. It requires disclosure of information on:

- restricted grants received whether accounted for as revenue or as a liability (para 6.7); and
- assets subject to specific restrictions (para 6.11); and
- changes in restrictions during the period (para 6.7).

New Zealand's approach to restricted contributions has similarities to Canada's fund accounting approach (Danyluk, 1993; CICA, 1993), with the exception that it

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adverse financial consequences for the entity, in that the entity is obliged to sacrifice service potential or future economic benefits to one or more other entities; and (c) the transaction or other event which gives rise to the obligation to sacrifice service potential or future economic benefits must have occurred" (NZSA, 1993c, SC, paras 7.10, 7.11).

[7]Where restrictions attached to a grant have not been met such a grant is not to be recognized as an asset by donors unless there is a contract specifying that the donee will return the restricted grant (NZSA, 1993b, para 5.4).

[8]In a circular to Crown Research Institutes, their auditors, and Treasury, the Deputy Controller and Auditor-General proposed that donees of restricted grants may not recognize them as a liability to the extent of unmet restrictions because the contract does not envisage the return of funds in respect of work uncompleted. He proposed that funds may be "carried over" into a new financial year only with the permission of the granting body (Deputy Controller and Auditor General, 1993). In this instance the financial statements of both the granting body and the recipient bodies are consolidated into the Financial Statements of the Government of New Zealand and it appears some consistency in accounting treatment was being sought.

does not require differentiation between temporary and permanent restrictions, and does not propose the use of fund accounting. The disclosure requirements are more extensive than those proposed in the United States where the financial reports present an adaptation of fund accounting in that the FASB requires disclosure only of the restricted income and net asset classifications.

In New Zealand, as occurs overseas, temporarily restricted income is common because of a "saving up" process in which funding is commonly raised for specific projects before the expenditure is undertaken, and a number of such projects could be occurring at any one time. Dixon & Rees (1984) reported fund accounting to be common (p36, p37, p39) although they observed very little information disclosure about restrictions (p35, p36).

The extent and detail of the information required by ED-70 indicates the likelihood, as suggested in Canada (Ernst & Young, 1992) that those organizations not using fund accounting may encounter difficulties complying with the reporting requirements and will find it necessary to adopt fund accounting in order to comply (see sections 3.5, 3.7, 3.12.1, 4.3.2).

5.4.3 Additions to/Distributions from Net Assets

The conceptual framework definitions require that direct additions to, or distributions from net assets may be made only by owners acting in their capacity as owners. Nonprofit organizations, not having such owners with a financial interest in the net assets are considered not to encounter such transactions.

New Zealand also considers that contributions by owners are contributions of equity (para 6.5) and that there are no contributions of capital unless they are from owners:

> Contributions may require expenditure on capital assets by the recipient but this requirement does not determine whether the sum received is a contribution by an owner, or is revenue. (NZSA, 1993b, para 6.7)

As in the other countries, the implications for nonprofit organizations are that a common practice in which capital or non-operating receipts are added to net assets without first being reported in the statement of activities will cease[9]. All such contributions will be required instead to be reported as revenue although the possibility of recognizing permanent endowment funds as a direct addition to net assets is discussed and opinions sought (NZSA, 1993b, discussion paper).

Overseas, in both Canada and the United Kingdom, variations in this approach have been noted (see section 4.3.3) with the outcome being that in Canada when fund accounting is not practised endowment funds and some contributed fixed assets[10] (or funds to purchase such fixed assets) are accepted as direct additions to net assets. In this proposal Canada appears to have moved away from the asset/liability view of the conceptual framework and towards an income/expense view.

5.4.4 Financial Performance Measures and Presentation

As has been observed in section 4.3.4 there have been some difficulties in developing a measure of operations of nonprofit organizations, with inability experienced in both the United States and the United Kingdom to come to any agreement over such a measure. The FASB has not specified an operating measure but suggests it as an intermediate calculation within the statement of activities, although it does permit a further statement reporting such a measure, stipulating only that the change in net assets be reported in that statement (Brown & Weiss, 1993; FASB, 1993c, SFAS 117, para23). Canada has attempted to define an

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[9]Most commonly the types of transactions credited direct to net assets have included: legacies, contributions of fixed assets or contributions restricted for the purpose of purchasing fixed assets, contributions of endowment funds.

[10]Those fixed assets that will not be amortized.

operations measure for those not using fund accounting by moving back to an income/expenditure approach, and for those using fund accounting by adding a capital fund to restricted funds (CICA, 1993). In the United Kingdom, however, the statement of activities has been modified to show an analysis of net movements in resources shown as fixed assets increases or decreases, and other (CARC, 1993) (see section 4.3.4).

These difficulties have resulted from the changed meaning attached to the change in net assets figure as compared with the previous meaning of the net surplus or deficit figure. Kerr (1989) in relation to nonprofit organizations considered that:

> If a concept of income more akin to operating income were adopted, some concept of contributed capital would be needed, and the problem of deciding between, say, grants that are revenue and grants that are to be considered capital contributions would then have to be faced. (Kerr, 1989, p60)

If, in New Zealand, the reported net surplus or deficit is considered to provide some measure of performance, then the conceptual view of additions to/distributions from net assets, together with any requirement that unspent restricted contributions be accounted for as revenue will probably be perceived as inconsistent with that meaning.

Dixon & Rees (1984) found that the net surplus or deficit figure was considered important (p17, p25), and this makes it likely that adjustments to the presentation of financial reports will be sought. Currently such adjustments would not be difficult as in New Zealand there is no standard requiring a particular presentation of financial reports of nonprofit organizations[11]. However, ED-67: *FRS9:*

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[11] SSAP9: *Information to be Disclosed in Company Balance Sheets and Profit and Loss Accounts* applies to companies only

Information to be Disclosed in Financial Statements - A Review of SSAP-9 proposes application to all organizations.

ED-67 does not appear to allow any of the approaches taken overseas as it requires the reporting of only revenue and expense in the statement of financial performance and very tightly constrains the operating surplus or deficit measure. It proposes an operating surplus or deficit as "a measure of financial performance during a period resulting from the transactions with and other events arising from non-owner sources excluding:

a) the change in equity resulting from extraordinary items,
b) changes in reserves, other than retained earnings, recognised in the statement of changes in financial wealth, and
c) fundamental errors" (NZSA, 1992, para 4.22).

In chapters 3 and 4 the needs of users of financial statements of nonprofit organizations were discussed. It was proposed that one of the difficulties the FASB has encountered with the presentation of these financial statements is a result of its failure to heed some of the clearly stated needs in its own conceptual framework. The FASB has concentrated on the depiction of restrictions and the changes in them but dismissed the statement that users require information about inflows and outflows of resources (FASB, 1992a, SFAC4, para 48; Bossio, 1985). Although it is stated that those resource flows that change net assets should be distinguished from those that do not change net assets, the statement of activities presentation it proposes concentrates only on the resources that change net assets. The proposal in SORP2 (CARC, 1993) appears to be much closer to being able to present the information stated to be sought.

The business style financial reporting format has already been extended to the public sector in New Zealand. It may be considered that this extension has been successful and therefore that it is also appropriate for the nonprofit sector.

However, concerns over this style of financial reporting may be raised following the recent public argument between the Minister of Education and New Zealand's universities over the setting of student fees for 1994 (Rentoul, 1993a; 1993b).

This raises the question over the varying levels of user understanding (see section 4.3.4, appendix 1) and the decision usefulness focus of the conceptual framework. Australia's Statement of Accounting Concepts 3: Qualitative *Characteristics of Financial Information* suggests that users of general purpose financial reports should seek professional advice to assist their understanding (para 37). Such a suggestion may be contrasted with Vatter's comments in Appendix 1 and with Canning (1929, p140), "it ought never to be forgotten that those who are capable of profiting by all the information the accountant is capable of giving are a very small number indeed."

In New Zealand, if the users of financial statements of nonprofit organizations are similar to those in the United States and the United Kingdom, there should be no assumption that the presentation of financial statements proposed in ED-67 will be useful for them. Although restricted income may be distinguished from unrestricted income ED-67 does not allow for reporting on resource flows that do not affect net assets. ED-70 does not distinguish between types of grants for nonprofit organizations; effectively they will all be required to be reported as revenue. The operating surplus or deficit proposed in ED-67 will also not allow for distinguishing between such grants. Consequently the proposal for the presentation of financial statements in ED-67 is unlikely to be accepted as the measure of performance it claims to be.

5.4.5 Net Assets

The concepts developed for the nonprofit sector reflect the view that financial reports should present totals for the entity and not merely consist of a succession of funds statements.

New Zealand appears to have disregarded both the FASB's classifications of net assets, and Canada's and SORP2's requirements that funds be shown (CARC, 1993, p54; CICA, 1992, para .010), requiring only disclosure of those transactions subject to restrictions. Although not stated, it appears to be assumed that financial reports in New Zealand are intended to present totals for the entity.

Dixon & Rees (1984) expressed concern that the multiple statements produced using fund accounting made financial reporting difficult to follow, especially where there was no statement for the organization as a whole (Dixon & Rees, 1984, p39). Their views were in accordance with those of the Commission on Private Philanthropy and Public Needs (Gross, 1975) and Weinstein (1978).

Given the observations of Dixon & Rees (1984) and possible incentives to adopt fund accounting (see section 4.2 above) some clarification of requirements may be necessary.

5.4.5 Reporting Entity

Financial Reports

The reporting entity concept is user oriented, requiring the preparation of general purpose external financial reports if dependent users exist:

> A reporting entity exists where it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them ... (NZSA, 1993c, para 2.1)
>
> ... the responsibility to report publicly is broader than the "legal" obligation and arises from:
>
> a) the role played in the community by the reporting entity; and/or

> b) users' reliance on general purpose financial reports for their information needs. (NZSA, 1993c, para 2.2)

The sorts of users likely to be dependent on such financial reports are considered to be providers of resources, including donors. In New Zealand, as in Australia, the implications of this concept are that even very small charities are likely to be required to produce such general purpose financial reports because of the existence of external users.

However, New Zealand has also issued an exposure draft proposing differential reporting which would allow some standards[12], or parts of them not to be observed by those organizations that qualify for exemption (NZSA, 1993d, para 1.2).

The philosophy behind the differential reporting proposal relates to the cost of complying with all accounting standards, aiming to reduce those costs for organizations considered to fall within three particular criteria:

- they do not have public accountability[13]; and either:
- all owners are also members of the governing body; or
- it does not qualify as a large entity[14]

Despite views expressed to the contrary that charities should be publicly accountable (Gross, 1975), they are unlikely to issue securities to the public or to have the ability to tax in order to obtain public funds. Charities are also defined as

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[12]The standards from which complete exemption is proposed are: SSAP-8: Accounting for Business Combinations, SSAP-10: Statement of Cash Flows and SSAP-23: Financial Reporting for Segments. Partial exemption is allowed from some others and one of these partial exemptions would allow financial statements to be presented inclusive or exclusive of GST, provided the method is followed consistently.

[13]"An entity is deemed to have public accountability if: at any time during the current or the preceding reporting period it had securities on issue to the public; or it can exercise coercive power; that is, it has the ability to tax, rate or levy to obtain public funds for its operations" (NZSA, 1993d, para 4.15).

[14]"An entity is deemed to be large if it exceeds any two of the following criteria: total revenue of $2.5 million; total assets of $1.5 million; 20 employees (NZSA, 1993d, para 4.19).

having no owners so the criterion considering whether all owners are members of the governing body does not apply. Consequently the decision whether charities may qualify for differential reporting appears to rest entirely on size.

In the United States there is some flexibility given to charities with a turnover of less than $150,000 (see section 3.5.1). In the United Kingdom charities with gross receipts of less than £25,000 are required to produce a summary of receipts and payments together with a statement of assets and liabilities, instead of the full general purpose external financial reports (CARC, 1993, p8).

There are no legal requirements that charities in New Zealand comply with the accounting standards issued by the New Zealand Society of Accountants or that they have their financial reports audited. However, to the extent that they seek out members of the Society to audit their financial reports the audit should be conducted according to audit standards and therefore the Society's standards would be applied.

Differential reporting may provide some relief to some of those charities currently following all accounting standards, however, to the extent that very small charitable organizations seek a Society member to conduct an audit, the resulting imposition of accounting standards may be expensive for those producing only statements of receipts and payments.

Controlled Organizations

The reporting entity concept defines the boundaries of an organization by considering the presence or absence of control over other organizations (see sections 3.12.2 and 4.3.6). The reporting entity concept has been adopted in New Zealand but does not refer to defining the boundaries in such a manner. Neither has the accounting standard SSAP8 *Accounting for Business Combinations* yet been revised.

TABLE 5.1
Control in New Zealand

	Criteria to Define and Determine the Existence of Control
Control	The power to govern the financial and operating policies of another entity for the purpose of obtaining the benefits and/or assuming the risks normally associated with ownership (NZSA, 1992, SSAP8, para 3.6).
Factors Indicating Control	Any of the following factors would indicate that one entity has the power to govern the financial and operating policies of another entity: (a) the power to determine the composition of the board ...; (b) the power to appoint or remove all or a majority of the board...; (c) the ability to control the casting of a majority of the votes cast at a meeting of the board ...; (d) the ability to cast, or control the casting of, more than half of the votes ... likely to be cast at a general meeting ...; (e) the guaranteeing of substantially all of the liabilities or other obligations ...; (f) under a statute or an agreement, or any other scheme, arrangement or device, or by the establishment of a trust deed, an entity obtains in-substance the majority of the benefits or assumes the majority of the risks ... (SSAP8, para 4.4).

As observed in section 3.12.2, Australia's definition of control does not appear to require control to be for the purpose of obtaining economic benefits, but merely for the purposes of achieving the objectives of the reporting organization. However, although Australia's reporting entity concept proposes criteria similar to those of Ball (1988) these criteria do not appear in the accounting standard.

The intentions of Australia's reporting entity concept are not yet clear (see section 3.12.2). Future modification of the indicators of control, however, may lead to a need, as in the United Kingdom, to make some specific provisions for organizations larger than those allowed for under New Zealand's differential reporting criteria[15].

[15] In the United Kingdom only large charity groups are required to produce consolidated financial reports. 'Large' groups are those meeting any two of the following criteria: gross resources (including intra group transactions) arising in the year exceeding 13,440,000 pounds; net resources exceeding 11,200,000 pounds; gross (including

Holder (1986) and Ball (1988) in his research monograph leading to Australia's reporting entity concept discussed indicators of control of nonprofit organizations. Canada has recently proposed indicators for the nonprofit sector (CICA, 1993) and the FASB also intends to address the topic in relation to the nonprofit sector. It appears that the matter will eventually be addressed in accounting standards.

5.5 AUDIT OF CHARITIES IN NEW ZEALAND

Although New Zealand's accounting standards apply to charities, the extent to which they are actually observed is likely to be determined in the auditing process. Dixon & Rees (1984) observed that auditors could improve the quality of the financial reports of nonprofit organizations. However, they considered such a task to be made difficult by low levels of understanding of accounting techniques and concepts found in those preparing the financial reports of nonprofit organizations. They also issued a reminder about the observance of auditing standards:

> It is worth re-emphasising that, even for an honorary audit of a small club or society, auditors who are members of the New Zealand Society of Accountants are required to follow all of the [auditing] standards. (Dixon & Rees, 1984, p53)

This view has recently been reiterated with a statement that the only acceptable reason for departure from those standards "is on grounds of materiality, and in this respect not-for-profit organisations are identical to commercial or government entities" (Lowe, 1993, p10). It is to be noted, however, that there appears to have been some acceptance of a different standard for auditing when the audit is an honorary one[16].

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intra group balances) aggregate balance sheet total of 6,720,000 pounds; net balance sheet total of 5,600,000 pounds; group employment of more than 250 persons (CARC, 1993, para 46).

[16] A newspaper article about the NZ Sports Foundation and the changes made following the imprisonment of its former executive director on major fraud charges reports " ... a new accounting system, with built in safeguards and controls, has been installed, and the foundation also has a new auditor, Price Waterhouse. Previously the foundation had an honorary auditor" (Tutty, 1993).

Findings overseas have indicated that some form of differential auditing appears to be applied to charities, in that audited financial reports issued by those charities may have unqualified audit reports attached although the financial reports do not comply with accounting standards. Dixon & Rees (1984) had discerned a similar trend in New Zealand in relation to nonprofit organizations.

In addition to the possible legal liabilities arising from such audit reports[17], any failure to apply accounting standards in auditing a charity may mean that accounting standards are perceived as not being relevant to charities. It may also increase the likelihood that representatives of the nonprofit sector will not become involved in the standard setting process because of this perceived irrelevance.

5.6 REGULATION OF CHARITIES IN NEW ZEALAND

In New Zealand there are fewer legal constraints imposed on charities than in other countries.

Charitable status is awarded to bodies meeting the Inland Revenue Department criteria and this involves an inspection of the constitution:

- the objects, to see if they are charitable[18];
- the alteration of rules clause;
- the winding up clause and how any remaining property is to be disposed of;
- whether the disposition of funds is limited to New Zealand; and

[17]Although one of the apparent reasons for failure to fully observe auditing standards has been a low perceived risk, New Zealand's Fair Trading Act has been cited as one which would allow a remedy against an auditor without the need to prove any loss arising from reliance on the financial statements (Walsh, 1993).

[18]Meeting any of the four heads of Pemsel's Case is sufficient for the objects to be deemed charitable. Those heads are: the relief of poverty, the advancement of education, the advancement of religion, and other purposes beneficial to the community not falling under any of the preceding heads (Lockhart, 1986). In New Zealand the Inland Revenue Department lost an action taken by the Centrepoint Community Growth Trust which which was judged to qualify under three of the four headings (Lockhart, 1986), while in the United States a headline in the LA Times announced that witches had won nonprofit tax status as a religion and hoped to shed their evil image (Harvard Law Review, 1993).

- whether a member is able to gain a pecuniary benefit (Working Party on Charities and Sporting Bodies, 1989; Inland Revenue Department, 1993).

There are no ongoing reporting requirements to the Inland Revenue Department in relation to charitable status. Such reporting requirements as there are relate to the legal form of the charity concerned. There are two main legal forms a charity may take in New Zealand: a charitable trust or an incorporated society although some other charities may be formed by Act of Parliament.

5.6.1 Charitable Trusts

Charitable trusts are governed by the Charitable Trusts Act 1957. Any unincorporated organization with principally charitable purposes may apply for incorporation under the Charitable Trusts Act (Charitable Trusts Act, 1957, para 8), however once incorporated under this act there are no ongoing public reporting requirements of any kind, although the charitable trust itself may specify some in its constitution (Lomas, 1992).

The Attorney General has the power under the Charitable Trusts Act to inquire into the management of charitable trusts, or of any charities. Should the trustees fail to comply with requests for information, each person is liable on conviction to a fine not exceeding $40 (Charitable Trusts Act, 1957, para 58).

Currently an information leaflet on the Charitable Trusts Act 1957 is being prepared[19], and subsequently the Act is to be reviewed (Lomas, 1992).

5.6.2 Incorporated Societies

Incorporated societies are governed by the Incorporated Societies Act 1908 and this act requires that a copy of the annual financial reports be filed with the

[19] This will be the first information leaflet produced in the thirty four years the Act has been in force (Lomas, 1992).

Registrar. There are no audit requirements but financial reports are to consist of an income and expenditure account, a statement of assets and liabilities, and notification of any charges affecting any of the property of the society (Incorporated Societies Act, 1908, para 23). Despite this requirement there are no regular checks to ensure that files of such organizations are kept up to date (Controller and Auditor-General, 1993).

The Registrar has powers under the Incorporated Societies Act to inquire into an incorporated society and failure to comply will incur liability to a fine of not more than $1,000 (Incorporated Societies Act, 1908, s34). An incorporated society may also be wound up by the court under certain circumstances (Incorporated Societies Act, 1908, s25).

5.6.3 Supervision of Charities

Consideration has been given to increasing the supervision of charities in New Zealand. In 1979 the Property Law and Equity Reform Committee reported on the Charitable Trusts Act 1957 noting that "charitable trusts are uniquely free from supervision" (Property Law and Equity Reform Committee, 1979, para 4). This committee reviewed the then existing law in other countries, considered the significance of audit[20], and concluded that the powers under the Act were adequate except that there should be a requirement that charitable trusts file financial reports (para 12).

The committee also examined the question of whether charities making public appeals should be required to register beforehand. Concerns about public appeals

[20] "... it is clearly within the professional obligations of an auditor concerned with the accounts of any trust to satisfy himself that payments are authorised in terms of the trust instrument" (Property Law and Equity Reform Committee, 1979, para 9(b)).

were noted[21] as was a question raised by the Minister of Justice of whether trusts soliciting funds from the public should be required to have their accounts audited (para 17). The committee recommended:

> That every charity making a public appeal for funds be required to have its accounts audited because:
>
> (a) an auditor has the expertise and status to advise the Attorney-General of any suspected malpractice;
>
> (b) major organisations already have their accounts audited at regular intervals;
>
> (c) provisions could be made for suitable exemptions from the audit requirements.
>
> That such audit be undertaken by a member of the New Zealand Society of Accountants. (Property Law and Equity Reform Committee, 1979, para 25)

No action was taken on those recommendations of the Property Law and Equity Reform Committee.

On 17 December 1987 a proposal to tax charities and remove donors' tax concessions was announced in an economic statement (Working Party on Charities and Sporting Bodies, 1989). Shortly afterwards this proposal was deferred and a working party established to "report on an appropriate taxation regime" (Working Party on Charities and Sporting Bodies, 1989, pii).

The terms of reference of the working party included:

> The regime should incorporate a role for a Commission for Voluntary Welfare Agencies and Sporting Organisations. It is envisaged that the Commission (a) shall determine the eligibility of organisations for any preferential tax treatment that the Working Party shall decide upon, and (b) may advise charities on the most efficient and effective use of their resources. The exact functions and responsibilities of the Commission will be determined by the Working Party. (Working Party on Charities and Sporting Bodies, 1989, ix)

The working party noted a rapid growth in the number of charitable trusts, the ineffectiveness of the Charitable Trusts Act 1957, and its lack of application to all

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[21] The then Associate-General Secretary of the National Council of Churches was quoted as stating that "[In] New Zealand ... the ordinary citizen has no means of finding out the legitimacy of the appeal. Nor can he tell whether it is functioning with any degree of efficiency" (Property Law and Equity Reform Committee, 1979, para 13).

charities. One of its recommendations was that there should be "a Commission for Charities established to oversee the activities of the majority of charitable and community groups, to register these groups for taxation purposes, and to monitor resources within the sector" (Working Party on Charities and Sporting Bodies, 1989, p2).

When the working party's report was issued it was accompanied by a press statement by the Minister of Finance and the Minister of Social Welfare. This statement discussed the recommendations made and stated that a decision on a Commission for Charities would be deferred. The reason for this deferral was stated to be in order to receive the views of interested parties before deciding whether such a commission would be in the interest of the country (Working Party on Charities and Sporting Bodies, 1989, pv). There appears to have been no further action since then.

In the last fourteen years two publicly paid working parties have examined charities and their regulatory environment and recommended that action be taken to increase the supervision of charities. No action has been taken on either recommendation.

> The New Zealand charitable sector is on the brink of major growth and development. Part of the motivation for this is simply a catching up as existing charities reduce their isolation and become aware of ways to increase the professionalism of their fundraising and to spend these funds in a manner to meet changing objectives. The philanthropic community is a world community and the increasing awareness of this will lead to changes in processes.
>
> Another motivation is the decline of the New Zealand public sector. This means that the community will be required increasingly to meet health, education and welfare needs which at one time were met through tax revenues.
>
> As the charitable sector expands, there will be an increasing need for charities to be accountable. (Working Party on Charities and Sporting Bodies, 1989, p90)

5.7 SUMMARY

Similar factors to those occurring overseas appear to be affecting charities in New Zealand. They have in the past received government funding for some of the welfare work they carry out. Economic and political changes accompanying new public management may be expected to result in an increase in the needs of charities for money and in their role. Some of the funding charities previously received has been cut while increasing requirements for their services have been observed. In addition, the provision of welfare services that are to be funded by the government are moving towards a formal contractual basis.

The New Zealand Society of Accountants has included the nonprofit sector in its conceptual framework and the accounting standards it promulgates generally apply to all entities including those in the nonprofit sector. The Society's standard setting process relies on participation by those affected making submissions on exposure drafts but concerns expressed by Porter about a general lack of such participation indicates that standards are likely to be promulgated with very little or no input from the nonprofit sector.

New Zealand's accounting standards are being applied to all sectors but ED-70 *Accounting for Grants and Donations* refers to many of the transactions that are being dealt with overseas by the issue of special standards. This exposure draft is likely to have a major effect on charities and the proposals in it have similarities to those proposed overseas, appearing to be merely applying the conceptual framework. However, it will also be affected by standards developing overseas. The proposed treatment for contributed services involves similar criteria to those proposed in Canada but instead of allowing a choice to recognize such services a requirement that they be recognized is proposed. Only the FASB has issued a requirement for recognition and although it appears to have justified its requirements using the conceptual framework those justifications are dubious and the New Zealand Society of Accountants has offered no explanation for such a requirement.

It is not clear from the wording of the references to restrictions on contributions whether a donee organization has the choice of recognizing restricted contributions as liabilities or as restricted income where the restrictions applying have not been met. However, the disclosures required about restricted contributions are such that, although fund accounting is not proposed, such accounting procedures may be necessary.

The view of additions to/distributions from net assets as adopted in ED-70 is clearly following the conceptual framework although information is being sought on views about endowment contributions.

Developing a measure of financial performance has been a problem arising from the approach being taken towards financial reporting for nonprofit organizations. This is affected by the presentation requirements for financial reports. If an operations measure is required there is no evidence of agreement having been reached overseas as to what an operations measure is for a nonprofit organization. The definition of the operations measure proposed in ED-67 is unlikely to be suitable, and, if restricted contributions are to be accounted for as revenue before those restrictions are met, a single column presentation also appears unlikely to be suitable.

The statement of activities developed for nonprofit organizations in the United States is at variance with the FASB's conceptual framework which states that users of financial reports of nonprofit organizations require information about inflows and outflows of resources. It fails to include in the report the outflows that do not affect net assets. The statement of financial activities developed for charities in the United Kingdom appears to show the most promise in meeting the stated reporting requirements. The stated difference in the focus of users of financial statements of nonprofit organizations leads to a view that a special standard covering presentation of financial statements of nonprofit organizations will be necessary.

The reporting entity concept raises questions about the logic of concluding that controlled charities as defined result in an economic entity. It also implies a need to consider whether consolidated financial reports should be produced for some organizations. The indicators of control used in the current accounting standard do not reflect those proposed in Australia's reporting entity concept. Indicators of control of nonprofit organizations have been proposed overseas and may be expected to be addressed eventually in New Zealand. Promulgation of such indicators, however, may result in major consolidations being required. There may be some need for a further level of differential reporting if the indicators of control are modified.

There appears to be a danger in promulgating standards that do not directly address nonprofit sector matters in that lack of representation of the sector in the standard setting process may result in special aspects being overlooked. Because the IASC excludes the nonprofit sector from its conceptual framework such an oversight will not be rectified merely by harmonization of New Zealand's standards with international ones.

Although charities are not legally required to comply with accounting standards those charities choosing to have their financial reports audited by a member of the New Zealand Society of Accountants may expect to find the accounting standards applied. It appeared in 1984 that in New Zealand, as was occurring overseas, there was a form of unofficial differential auditing with relation to nonprofit organizations. Reminders of professional obligations were issued. In addition to concern for auditors in relation to increased risk resulting from the Fair Trading Act, such auditing is likely to lower participation by the nonprofit sector in the accounting standard setting process because accounting standards may be perceived as irrelevant.

The observation fourteen years ago that "charitable trusts are uniquely free from supervision" is still true today despite recommendations of two working parties, one in 1979 and the other in 1989. As was noted in 1989 the charitable sector is growing and part of the reason for this growth is that these organizations are being required to meet needs which were previously met by public sector bodies. This growth may be expected to continue especially as the contracting out of what were previously government provided services continues.

CHAPTER 6

RESEARCH METHOD

6.1 INTRODUCTION

Internationally the nonprofit sector has ranked behind the business or for-profit sector in the development of accounting standards, and the application of them, with divergent treatments of charities being the result. In the United States the work of Anthony (1978) appears to have led to the nonprofit sector being included in the FASB's, and consequently other, conceptual framework projects and yet he has been one of the strongest critics of that inclusion maintaining that it does not recognise the major difference between for-profit and nonprofit organizations (Anthony, 1983, 1989, 1993).

In the UK, low compliance with SORP2 (ASC, 1988) was attributed to it not being mandatory (Hines & Jones, 1992). The Charity Accounting Review Committee's 1993 exposure draft of a new version of SORP2 departs from the previous one and this may be attributed to lack of acceptance of SORP2 by the charities themselves.

Some of those criticizing the inclusion of the nonprofit sector in conceptual framework projects acknowledge considerable diversity in the nonprofit sector. They have also shown some agreement over the types of nonprofit organizations which should not be included in the conceptual framework projects, or within which accounting problems are most likely to occur if included.

Anthony (1978) considered that accounting problems peculiar to nonprofit organizations tended to be concentrated in those organizations financing operations from sources of finance other than the sale of goods and services, such sources including grants and donations. He saw problems related to restrictions placed on the use of resources and a need to distinguish between operating and capital inflows.

Falk (1992) advocated classifying nonprofit organizations in a two by two matrix (club or non-club; producing collective goods or services, or producing private goods or services). He considered that all organizations in the non-club category should be excluded from the conceptual framework and instead require itemised budgetary control and fund accounting on a cash basis.

Beechy & Zimmerman (1992) supported Falk's view but on a programme basis rather than an organization basis. They maintained that non-clubs delivering collective goods required different financial reporting from other nonprofit organizations. The latter should adopt business GAAP including recognizing donations for capital purposes as revenue.

The criticisms over the inclusion of the nonprofit sector and the narrowing of disputes over the applicability of the conceptual framework definitions have led to the debate continuing, at least for non-clubs delivering collective goods. Charities tend to fall into this classification and consequently any special study of nonprofit organizations in New Zealand is likely to be more useful if it concentrates on charities alone.

This chapter outlines the two major approaches to the development of accounting theory for standard setting, considering the advantages and disadvantages of each. It then discusses the combination of both these approaches, proposing that this research may be used to assist in such a combination in New

Zealand. The apparent reception of exposure drafts and standards promulgated for the nonprofit sector since Anthony's 1978 research study suggests that some of the difficulties in establishing acceptable standards relate to failure to take adequate cognizance of empirical research. There has been little such research into the nonprofit sector in New Zealand. Consequently the research design and methodology proposes an exploratory research method to identify special issues of accounting for charities in New Zealand.

6.2 NORMATIVE ACCOUNTING AND LINKS TO EMPIRICAL UNDERSTANDING

There have been two major approaches to the development of accounting theory both of which have had some success and have been criticised:

6.2.1 Descriptive Accounting Theory

A descriptive, or empirical, approach to accounting theory aims to describe current practice, developing principles to improve practice from "a distillation of experience" (Storey, 1964, p47). The descriptive approach has tended to be accepted in practice but has been criticised for being a 'piecemeal' approach that is merely descriptive of current practice[1] rather than leading to improvement in that practice[2] (Storey, 1964). Although empirical research is acknowledged to be "partial and incomplete", it is considered to add richness and understanding to the

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[1] In 1970 the Accounting Practices Board produced APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. This statement received heavy criticism for relying too much on practice. (Kirk, 1989b)

[2] There was heavy criticism of the practices Sanders, Hatfield and Moore (1938) appeared to condone in their work, *A Statement of Accounting Principles*. Storey noted, however, that the practices criticised had been discontinued by the late 1940s or early 1950s and that the end of these practices was brought about by the AICPA which used a descriptive approach to the development of accounting.

processes being researched and this understanding helps provide the grounding to prescribe changes that should be made (Laughlin, 1992, p1).

Two particular problems noted with the descriptive approach were that it did not help to lead the profession towards a conceptual basis, and that solutions found using the descriptive approach tended to be short-lived, causing other accounting problems (Storey, 1964, p52).

6.2.2 Normative accounting theory

The normative or conceptual approach to accounting theory aims to prescribe 'correct' methods of accounting (Hodgson, Holmes & Kam, 1992, p.357). It is assumed that from normative theory deductive reasoning will allow standards to be developed[3]. Chambers was credited with increasing the focus on normative research in accounting when, in 1955, he expressed the view that accounting research should be less concerned with justifying what is and more concerned with developing what should be (Henderson & Peirson, 1978, p28). The benefit of developing a normative approach to accounting theory is considered to be that such an approach allows a "complete and comprehensive codification ... by which to evaluate rules and procedures[4]" (Storey, 1964, p47).

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[3]As a part of its definition of a conceptual framework the FASB stated that "... concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting standards" (FSAB, 1976, p2).

[4]Kirk (1988) with reference to his involvement early in the conceptual framework project stated, "If the development of objectives of financial statements, definitions of the elements thereof, and other concepts would help show the way by logical deduction to sound and consistent standards, I was all for it." (Kirk, 1988, p12).

Despite attempts to develop a normative accounting theory, it has tended not to be readily adopted in practice[5]. Jensen (1983) criticised normative accounting theory maintaining that to be able to prescribe 'correct' methods of accounting one must comprehend the underlying operations. Laughlin also criticised the normative approach to accounting research noting that:

> The suggested design for accounting systems seemed to have an irrelevance to current practices. This led to calls for a greater descriptive understanding of the functioning of current accounting practices in the hope that such an appreciation would lead to the design of more meaningful and appropriate normative systems. (Laughlin, 1992, p1)

6.2.3 Summary

Both of the two major approaches to accounting theory have benefits and drawbacks. The normative approach has the benefit of developing a conceptual view from which to deduce standards, but has the drawback of tending to result in standards considered unacceptable in practice; the descriptive approach has the benefit of being supported in practice, but has the drawback of being a piecemeal approach in that it does not lead to a conceptual basis for accounting, and solutions found may cause other problems.

6.3 PROPOSALS FOR A COMBINATION OF BOTH APPROACHES

Neither the normative approach nor the descriptive approach has been shown to be successful in establishing accounting standards if used alone but a combination of both approaches has been proposed as effective. Kirk used a legal quote referring to an analogous situation in law:

> The whole outline of the law, as it stands today, is the resultant of a conflict between logic and good sense - the one striving to carry fictions out to consistent results, the

[5]Storey (1964) outlined the efforts of the American Accounting Association to develop a conceptual approach to accounting. Because its approach tended to develop ideas that conflicted with practice the standards it put forward were prone to lack of acceptance. (Storey, 1964, p47).

other restraining and at last overcoming that effort when the results become manifestly unjust. (Kirk, 1989b, p85)

Storey[6], having outlined the efforts of both the normative and descriptive approaches, and failure at that time to develop statements of principles proposed:

> A serious attempt to unite the practical experience of the practicing accountant and the research potential and the preoccupation with logical methods and conceptual matters of the university professor. (Storey, 1964, p57).

His argument was that he considered 'neither the conceptual nor the piecemeal approach' should be followed to the exclusion of the other. A similar view was stated by Kirk when reviewing his time at the FASB and the progress made on the conceptual framework project:

> A normative system ... has definite limits in its ability to point a policy making body toward incontrovertible solutions to recognition and measurement problems. (Kirk, 1988, p17)

Kirk quoted Dyckman and Morse[7] in stating the need for both types of research to enable wise decisions in standard setting,

> Analytical research provides theories on how information should be used in markets. Empirical research attempts to describe how information is actually being used in markets. The joint results from this research can then ideally be used by policymaking bodies that regulate accounting choice. (Kirk, 1988, p17)

Horngren (1981) considered a normative approach to be only one aspect of a policy making process and an especially limited one when social choices are involved. Several members of the FASB have discussed how a combined approach is used in the standard setting process.

Beresford (1988) considered standard setting to be a 'balancing act', and pointed out that the mission of the FASB includes a requirement that it follow a number of

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[6]Storey was later involved in the FASB's conceptual framework project.

[7]Thomas R. Dyckman and Dale Morse, Efficient Capital Markets and Accounting: A Critical Analysis (Englewood Cliffs, NJ.: Prentice-Hall, 1986) p85

precepts, the first being "... to weigh carefully the views of its constituents in developing concepts and standards" (Beresford, 1988, p4).

Beresford outlined the time the FASB spent developing an understanding of issues, and described the decision process as "a very human, judgmental process" noting that, having weighed all of the input and made a decision, the final answer would not please everyone.

Difficulties balancing conceptual and practical matters have been acknowledged. Brown (1990) outlined the process used by the FASB in achieving such a balance, the practical matters including cost/benefit considerations and economic consequences:

> The FASB has attempted to strike this balance by giving paramount consideration to agreed concept, principles, and logical consistency in setting accounting standards. The answer produced by following this process is presumptively adopted, absent compelling evidence that cost/benefit and economic consequence considerations would make the solution unacceptable. (Brown, 1990, p95)

He acknowledged, however, that the judgement of when those consequences become unacceptable is a difficult and challenging task, while Wyatt (1991) voiced concern at the lack of diversity of perspectives involved in that decision process.

Beresford (1988) referred to the standard promulgated by the FASB on accounting for income taxes as an example of the result of the balancing process. He pointed out that:

> The standard does not represent purely a conceptual answer. Nor is it an answer popular with preparers but one that requires a major crack in the conceptual foundation for a liability method. ... I voted for the Statement and view it as an appropriate solution to the conceptual and practical issues that we faced on this project. ... I believe the process is working well, and I am satisfied that we are considering both the theoretical and practical aspects of what we do. And this 'balancing act' between theory and practice is ... important in ... reaching our final decisions. (Beresford, 1988, p7)

The approach outlined by FASB members indicates a likelihood that standard setting in New Zealand will take a strongly conceptual approach in the absence of persuasive evidence of unacceptable consequences. The dearth of research in New Zealand on financial accounting in the nonprofit sector, and in particular on charities, together with a likely lack of involvement by charities in the standard setting process[8] means that current moves to explicitly encompass nonprofit organizations in the conceptual frameworks and to issue standards applying these concepts may be expected to result in the required 'compelling evidence' of unacceptable consequences not being provided. It is hoped that this research will assist in providing such evidence.

6.4 STANDARD SETTING FOR THE NONPROFIT SECTOR

The recent development of most standards for the nonprofit sector has involved the examination of the financial statements of nonprofit entities (Anthony, 1978; CICA, 1980; Bird & Morgan-Jones, 1981). However, the resulting standards have often been at variance with the results of the empirical research. One of the most significant of these differences is that all of the researchers above drew their conclusions on the basis that nonprofit organizations received contributions of capital from members or donors (Anthony, 1978, p170; CICA, 1980, p35; Bird & Morgan-Jones, 1981, p228). The standards proposed, which are clearly derived from the conceptual framework projects, consider that additions to 'capital' can be made only by owners. As nonprofit organizations tend to be characterised by lack of owners, all contributions are therefore classified as income, thus denying the recognition of direct additions to capital[9].

[8]Research evidence has shown overseas and in New Zealand that nonprofit organizations frequently do not follow accounting standards and auditors have not been drawing attention to this failure. Low awareness of the standard setting process and effects of standards is therefore, predictable.

[9]SORP2 (1988) allowed an exception in the case of receipt of endowment funds which it classified as capital (ASC, 1988, para 26), CICA (1993) has proposed a number of direct additions to net assets for those nonprofit organizations not using fund accounting.

Only in the UK has the general approach taken by standards setters to nonprofit organizations become operational. SORP2 took effect as recommendations in 1988 and, although it was expected that the Charity Commission would make SORP2 mandatory (Hines & Jones, 1992) following the 1992 Charities Act, the Charity Commission has instead issued an exposure draft of a revised SORP2. That exposure draft, as outlined in chapter 3, proposes that the income and expenditure statement be replaced with a different statement (a statement of financial activities) and this move is clearly one with which the Accounting Standards Board does not fully concur (Charity Commissioners, 1993b). It was indicated to me that the exposure draft was promulgated following submissions by the Charity Finance Directors Group[10]. It appears there is dissatisfaction with the income and expenditure report produced using SORP2, and this may, at least partly, be a result of the classification requiring all contributions, other than endowment funds to be reported as income.

Neither the United States nor Canada yet has in force the standards proposed for the nonprofit sector. Both have observed much dissent with the standards proposed, with Anthony being an especially harsh critic[11]. The United States has issued a final standard that will take effect in 1995. This was after issuing two exposure drafts, conducting field tests and noting areas of agreement and controversy in developing those final standards. The FASB has accepted that an unspecified financial operations measure may be reported (Brown & Weiss, 1993). The Canadians have issued a second exposure draft and have been conducting field tests, but have not yet issued a final standard.

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[10]Interview, 15 July 1993.

[11]Anthony's latest article criticizing the proposed standards describes them as "foolish" and likely to result in misleading financial statements (Anthony, 1993).

The American and Canadian standard setting bodies appear to be finding difficulty achieving a level of acceptability with their proposed standards,[12] and it appears that SORP2 (ASC, 1988) is also suffering from a similar problem. This apparent lack of acceptance may be evidence in support of Kirk's view that applying normative conceptual framework definitions to the nonprofit sector while apparently ignoring or overlooking empirical research is not a tolerable way of setting standards. Kirk observed that "standard setters need and, if wise, use research - both analytical and empirical - to assist in making difficult choices" (Kirk, 1988, p17).

There has been little empirical research into the financial reporting of the nonprofit sector in New Zealand other than that of Dixon & Rees (1984). It is proposed in this thesis to carry out empirical research into charities as these are representative of those entities in the nonprofit sector most likely to encounter difficulties as a result of the conceptual framework being applied to them (Anthony, 1978; Falk, 1992; Beechy & Zimmerman, 1992). As has been outlined by Beresford (1988) and Brown (1990), there is a need to balance both conceptual purity and practical situations in setting standards. Evidence of those practical situations is needed, and empirical research into the subject should help in developing such an understanding, especially if, through lack of awareness, the nonprofit sector does not respond effectively to normatively derived exposure drafts.

[12] Anthony's view is that nonprofit organizations will not comply with the standards (Anthony, 1993, p57).

6.5 RESEARCH DESIGN

This thesis proposes that there are special issues of accounting for charities in New Zealand and these may be overlooked in applying the conceptual framework when setting accounting standards. With clear evidence that major changes in accounting by charities will be required, and apparent resistance to those changes overseas, some understanding of both the current state of financial reporting by charities in New Zealand, and the perspectives of those involved in and affected by that financial reporting is necessary.

Laughlin (1992) observes that empirical research can be conducted using a high or a low level theoretical model. At the high level, which excludes "values and concerns about society" a theoretical model of what should be seen is used, while at the low level those values and concerns are important, with the observer "... involved in the observation process completely uncluttered by theoretical rules and regulations on what is to be seen" (Laughlin, 1992, p5). In order to understand the perceptions of those involved in and affected by the financial reporting of charities a low level theoretical model has been chosen. A low level approach tends to rely on the perceptions of the observer (Laughlin, 1992).

6.5.1 Research Strategy

Yin (1989) provides guidance for determining research methodology and described three conditions which must be considered when deciding on a research strategy:

- the research question,
- whether the researcher has any control over behavioural events,
- whether the research focuses on contemporary events (p13).

a) The Research Question

Yin proposed a classification scheme for research questions based on 'who', 'what', 'where', 'when', and 'why' (p17). In this thesis the research question would become 'what are the special issues of accounting for charities in New Zealand.'

Yin considered that there are two types of 'what' questions:

- an exploratory 'what' that he considered to be justification for undertaking an exploratory study with the aim of developing hypotheses for further research; and
- a quantification 'what' that is the equivalent of a 'how many' question (p19).

The 'what' question being asked is not to be answered with an enumeration of special issues, but with some attempt to develop an understanding of those issues in the hope that such understanding will be considered by standard setters and lead to further research. Yin considered that any research strategy could be used with an exploratory 'what' question.

b) Control over Behavioural Events and Contemporary Events

Where the researcher has no control over behavioural events (production of financial reports) and the events are contemporary, in that they are currently occurring, Yin recommends the use of a survey or archival analysis or case study. However, he maintained that in any survey there is limited ability to fully understand the complexity of the occurences observed (Yin, p14).

6.5.2 Unit of Analysis

Yin maintains that the unit of analysis is related to the research question. In this thesis the unit of analysis is charities in New Zealand with the research aiming to identify special issues of accounting for charities.

Yin also maintained that differences from earlier studies should be clear, allowing the extent to which earlier studies may be used as a guide for the study to be clear (p33). The focus of this research is on charities and consequently the work most closely referred to is the work of Bird & Morgan-Jones (1981) who also concentrated on charities. They approached the one hundred largest fund-raising charities in the United Kingdom. They also conducted a literature search, considered users of financial reports and surveyed a number of grant making trusts as well as consulting representatives of charities (Bird & Morgan-Jones, 1981, preface, p11, p136).

In New Zealand there appears to be no collection point for data on the largest charities or largest fund-raisers. What legal reporting requirements there are relate to the legal form the charity takes. Most commonly these legal forms are: an incorporated society, a charitable trust, or, occasionally, a charity created by special act of parliament. An incorporated society is required under the Incorporated Societies Act 1908 to file a copy of its financial statements with the registrar of incorporated societies but many incorporated societies are not charities. Charitable trusts have no public filing requirement at all. Charities established by act of parliament have requirements in their own act.

A generally applicable differential reporting framework has been proposed for New Zealand, ED-62 *Framework for Differential Reporting.* This classifies as 'large' any entity exceeding any two of (NZSA, 1993d, para 4.18):

- total revenue of $2.5 million,
- total assets of $1.5 million,
- twenty employees.

In the survey undertaken by Dixon & Rees (1984) only 9% of their subject group reported total assets of more than $1 million[13]. (There is no indication of size by number of employees, and the information on turnover is unclear.) Their 'random'[14] sample meant that the organizations they surveyed were predominantly quite small in terms of total reported assets.

Considering the definition of large in ED-62, the size of organizations involved in the Dixon & Rees survey, and the approach of Bird & Morgan-Jones, leads to a decision to concentrate on large charities.

In the absence of available information on large charities it has been assumed that those making national appeals are likely to be among the largest charities. The National Appeals Board co-ordinates the dates of national appeals of some, but not all charitable organizations carrying out national appeals to the general public. The membership list containing some 39 members was obtained and to this was added two other organizations, a church and a mission arm of a church. This resulted in a small non-representative survey. It was small in that a total of only 43 organizations were approached and non-representative in that it was a deliberate attempt to obtain the involvement of larger charitable organizations using the membership listing of an organization to which those larger organizations may or may not belong.

[13]There was no analysis above $1 million.

[14]Dixon & Rees called their survey a random sample but acknowledged sampling problems due to lack of any population listing of nonprofit organizations (Dixon & Rees, 1984, p7).

6.5.3 Linking Data to Propositions and Criteria for Interpreting the Findings

These steps are identified by Yin as the data analysis steps. One such method of data analysis proposed by Yin is pattern matching where "several pieces of information ... may be related to some theoretical proposition" (Yin, p33).

A pattern of failure to meet accounting standards, assertions of manipulation of financial results and failure of auditors to qualify audit reports has been found elsewhere (Bird & Morgan-Jones, 1981; Falk, 1981; Figlewicz et al, 1985). Dixon and Rees (1984) also found with nonprofit organizations in New Zealand that there was a failure to meet accounting standards and a failure of auditors to qualify audit reports. More than once it has been claimed that 'pleading poor' would result in increased donations (Hines & Jones, 1992; Weinstein, 1978). It may be that such a practice, if it exists among charities in New Zealand, is evidence of special issues relating to accounting for charities.

6.5.4 Triangulation

Yin emphasised the importance of triangulation, the collection of data from multiple sources. Although he considered case studies provide a good opportunity to use a wide variety of evidence, any other strategy could be modified to allow that (p96).

Yin maintained that multiple sources of information providing some corroboration would strengthen a conclusion (p97) and proposed six sources of evidence for gathering from multiple sources: documentation, archival records, interviews, direct observations, participant-observation, and physical artifacts (p85).

The initial aim of this survey is to analyse financial reports and constitutions to determine whether a pattern of non-compliance with accounting standards and non-qualified audit reports similar to that observed overseas, and in New Zealand nine years earlier, still exists or whether any other pattern may emerge.

Instead of merely discovering whether there is a pattern in New Zealand which matches that observed in other countries, it is also intended to investigate why such a pattern might exist, and what other factors may be involved. To develop an understanding of this, representatives of most charities taking part in the survey were interviewed, as were a number of representatives of funding organizations and three auditors. The interviews contained both open and closed questions aiming to gain additional information not provided by the documents examined, and seeking confirmation or otherwise of what appeared to be established facts. The interviews are intended to expand the richness of the perceptions and perspective of those involved in or affected by charity accounting.

This triangulation then includes the inspection of two different types of documentary evidence (three years of financial statements and constitutions) and three different types of 'representative' affected by the financial reporting of charities: representatives of the charities themselves, of funding organisations and auditors.

6.6 SUMMARY

For many years the financial reporting practices of the nonprofit sector was largely disregarded by the accounting profession. The result has been the development of a variety of accounting practices, and an apparent failure by auditors to seek compliance with applicable standards already developed.

The empirical research carried out in the late 1970s and early 1980s coincided with conceptual framework developments and resulted in the nonprofit sector being encompassed in those conceptual framework projects which were seen as improving on the previously largely descriptive approach. Reliance on the descriptive approach, which did achieve improvements and tended to be more acceptable in practice has been reduced, and a more normative approach has been taken, which has had the drawback of sometimes being unacceptable in practice.

The consequences of applying a normative conceptual framework to previously diverse accounting practices are that major changes to the financial reporting of these organizations are being proposed in a relatively short space of time. Changes of this magnitude have been unacceptable in the business sector, leading to major cracks in the conceptual framework being noted.

Members of the FASB have acknowledged that a totally normative approach is not intended, that the standard setting process is a 'balancing act', and that the views of the constituents are carefully weighed. However, concern has been expressed over difficulties in obtaining such a diversity of views.

In setting a standard, it appears that first a normative approach is taken and then for the 'balancing act' to be effective the constituents' views are required. With the observed low compliance with accounting standards by nonprofit organizations it seems reasonable to assume that the representation of those organizations at the 'balancing act' stage is likely to be inadequate and therefore it is more likely that unacceptable normative standards will be promulgated.

Charities have been identified as the type of nonprofit organization most likely to suffer from imposition of the conceptual framework and the standards likely to be developed from that framework. This research, which is exploratory in nature, aims to identify whether there are any special issues of accounting for charities in New Zealand. The method chosen is to identify and survey a sample of larger charities, examine their constitutions and financial reports, and interview representatives of those charities, a number of funding organizations, and some auditors.

It is hoped that by using multiple sources of information some corroboration will be provided to strengthen any conclusions drawn. It is also hoped that, for the standard setting process, in the absence of adequate direct representation of these organizations in the 'balancing act,' the conclusions drawn will be taken into consideration.

CHAPTER 7

ANALYSIS OF FINANCIAL REPORTS

7.1 INTRODUCTION

The inclusion of the nonprofit sector in the FASB's conceptual framework followed from a report issued in 1975 by the Commission on Private Philanthropy and Public Needs. This committee recommended that a "single uniform set of accounting principles" (Figlewicz et al, 1985, p81) be followed by nonprofit organizations. It also observed difficulties understanding fund accounting which was widely practised by nonprofit organizations in the United States.

Anthony's research study identified two major differences between the transactions of nonprofit and business organizations: "account[ing] for restrictions on spending, ... [and] ... distinguishing between operating resource inflows and capital inflows" (Anthony, 1978). Following this research study and the issue of the fourth concepts statement identifying the objectives of financial reporting of such organizations the FASB decided to incorporate the nonprofit sector into its developing conceptual framework. It addressed the differences Anthony (1978) identified by adopting the fund accounting concept of restrictions and by defining additions to capital as deriving from owners, so that for a nonprofit organization all contributions were classified as income.

The incorporation of the nonprofit sector into the FASB's conceptual framework has been criticized by some, including those who maintain that service facilities should not be capitalized (Mautz, 1989), a reporting format similar to business organizations would be misleading (Herzlinger & Sherman, 1980) and those who maintain that some parts of the nonprofit sector should be excluded from the conceptual framework, should not be required to capitalize fixed assets and should be using fund accounting (Falk, 1992; Beechy & Zimmerman, 1992).

SFAC4 detailed the needs of users of financial reports of nonprofit organizations. Bossio (1985) stated the difference in focus of these users as compared with those of the financial reports of a business organization. Specifically, the users of financial reports of nonprofit organizations were considered to need "information about the amounts and kinds of inflows and outflows of resources during a period" (FASB, 1992a, SFAC4, para 48; Bossio, 1985). Such a statement is commonly presented using fund accounting. However, in developing a method of presentation for financial reports, the FASB dismissed that information requirement (FASB, 1993c, SFAS117, para 46). It has attempted to define an operations measure and has failed. In the United Kingdom a statement of financial activities which, it is claimed will provide such a focus appears likely to be accepted (Framjee, 1993). New Zealand, like the FASB, currently proposes a statement of financial performance that restrictively specifies an operations measure.

There are similarities among those organizations proposed as likely to encounter difficulties with the approach of the conceptual framework. Charities are typical of these organizations as they commonly are financed by non-reciprocal transfers such as grants and contributions (Anthony, 1978), "provide products or services for free (or below cost), resulting in an unreciprocated outflow that is balanced by resources received via unreciprocated contributions" (Falk, 1992) and "offer collective goods with funds provided in fixed amounts by granting agencies" (Beechy & Zimmerman, 1992).

Findings overseas have been that nonprofit organizations, including charities, commonly do not comply with accounting standards, and that this lack of compliance has not necessarily been commented on in the reports of auditors (section 4.5). It has also been found that the net surplus or deficit reported is considered to be a measure of performance and that the financial reports of charities may be manipulated in order to plead poor (section 3.12.1.c).

The fragmentation of nonprofit organizations was also observed overseas, this involving a proliferation of divisions (section 3.12.2) and the formation of separate foundations which receive funds on behalf of other organizations (section 4.3.6). This has been stated to lead to confusion, with fragments sometimes omitted from financial reports (section 4.3.6).

For this research 43 charities were written to seeking their involvement and asking for a copy of:

- their constitution; and
- their financial reports for the most recent three financial years.

Thirty five charities agreed to take part in the research, thirty four (97%) provided financial reports and thirty two (91%) provided constitutions or rules. This chapter outlines the information extracted through examination of constitutions and financial reports. Although the financial reports for three years were sought the information presented is from the most recent one[1].

In analyzing the financial reports the variations observed in the entity reported on were such that a separate chapter has been devoted to this subject (chapter 8).

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[1] The availablity of three years' reports enabled comparisons over time, aided in any reconciliations required and in developing an understanding of likely policies where they were not stated.

A number of charities utilize some form of fund accounting and in some cases information was either not disclosed or was presented in a misleading manner. This was a factor hampering the crude calculation of financial size of the charities surveyed. These calculations show that more than half of the charities appear to fall below the proposed threshold for differential reporting, however, in some cases lack of information means that the calculations are probably inaccurate and most likely understated.

A check for the existence of basic financial statements and basic accounting practices showed some omissions and explanations for these omissions were sought. The chapter also includes a brief overview of the audit reports issued but these reports are examined in more depth in chapter 9.

Although charities demonstrate an intention to provide audited financial reports accounting for the resources entrusted to them there appears to be problems with some of these financial statements. Some problems, such as the variety of methods of presentation, may be solved by the promulgation of accounting standards while others, such as disclosure failures, failure to provide basic accounting statements and to observe basic accounting practices could be addressed by the charities and their auditors.

7.2 EXAMINATION OF CONSTITUTIONS

The constitutions or rules were examined:

- to determine the legal status of the charities surveyed;
- to ascertain any self-imposed reporting and auditing requirements specified; and,
- to detect any references to other organizations that may control or be controlled by the charity.

TABLE 7.1
Legal Status of Charities Surveyed

Legal Status	Number	%
Incorporated Societies	15	44
Charitable Trusts	14	41
Established by Act of Parliament	2	6
Unincorporated as a legal entity	3	9
TOTAL	34	100

The three unincorporated organizations include a charity which operates as a joint venture among several churches, a church organization which itself is unincorporated but includes a charitable trust, and a charity which has established a charitable trust but operates as an unincorporated body.

TABLE 7.2
Financial Reporting Requirements Specified in Constitution

Financial Reporting Requirements	Number	%
Balance Sheet, Income and Expenditure Statement	15	47
Financial reports, financial statements, accounts, financial affairs	9	28
Receipts and Expenditure, Assets and Liabilities	1	3
All monies received and paid, financial statements	1	3
Consolidated Accounts	1	3
Confirmation of income raised and applied to the field	1	3
No financial reports specified	4	13
TOTAL	32	100

Two of those that did not specify financial reporting requirements are incorporated societies with requirements imposed under the Incorporated Societies Act 1908. Of the remaining two, one was an unincorporated body whose rules were silent as to the specifications for its financial reports, and one was established by Act of Parliament. Two charities also specified that budgets be produced, but these were not presented with the annual financial reports.

TABLE 7.3
Auditing Requirements Specified in Constitution

Auditing Requirements	Number	%
Financial reports to be audited	20	63
Financial reports to be audited by a professional auditor	9	28
One auditor if chartered accountant, two auditors if not chartered accountant	1	3
May appoint an auditor	1	3
Silent	1	3
Total	32	100

TABLE 7.4
Evidence of Possibly Controlling, Controlled or Related Organizations

	Number
Possibly Controlling or Related Organizations	11
Possibly Controlled or Related Organizations	23

7.3 EXAMINATION OF FINANCIAL REPORTS

All of the financial reports received were examined and analyzed to identify:

- the size of each charity based on gross reported income and total reported assets;
- the existence of basic financial statements: balance sheet, income and expenditure statement, statement of cash flow, and statement of accounting policies;
- the existence of basic accounting practices: accrual accounting, capitalization and depreciation of fixed assets;
- apparent related party transactions and disclosures; and
- the types of qualifications included in audit reports and the issuers of those reports.

Two issues emerged during this analysis stage:

- the variety of entities reported on; and
- the variety of apparently acceptable fund accounting methods practised.

Both of these issues contributed to the view that classification of charities by size based on gross reported income and total reported assets is currently unreliable. Other contributing factors to this view include a few failures to observe the basic accounting practices, however, the concept of the reporting entity and the varieties of fund accounting, particularly where transactions through some funds are not disclosed, appear to lead to the greatest unreliability. Until the concept of the reporting entity is appropriately clarified and observed and some codification of acceptable fund accounting practices is carried out these crude classifications of size will remain unreliable.

7.3.1 The Reporting Entity

The concept of the reporting entity has been stated to be fundamental to accounting because failure of an entity, or of parts of an entity, to report would cause greater reporting deficiencies than failure to present clearly the information that is reported (Ball, 1988). In respect of charities and nonprofit organizations inconsistencies have been observed in the entity being reported on (Bird & Morgan-Jones, 1981; Holder, 1986) and similar inconsistencies were found in the financial reports of charities in New Zealand. Because this is a major issue Chapter 8 will be devoted to the reporting entity concept.

7.3.2 Fund Accounting

At the time of analyzing the financial reports of charities and interviewing the representatives of charities it was not clear how strongly based in fund accounting is SFAC4: *Statement of Objectives of Financial Reports of Nonbusiness Organizations* and the concept of restrictions. Fund accounting practices were common although fund accounting appears to receive little acknowledgement from the accounting profession in New Zealand. There are no standards or generally accepted practices for fund accounting in New Zealand so the forms observed were simply classified into two broad categories:

- partial fund accounting; a separate income and expenditure statement for each fund, but only one balance sheet for the whole organization;
- full fund accounting; a separate income and expenditure statement, and a balance sheet for each fund.

TABLE 7.5
Prevalence of Fund Accounting Practices

Fund Accounting Practice	Number	%
Partial Fund Accounting	15	44
Full Fund Accounting	3	9
No evidence of fund accounting	16	47
TOTAL	34	100

In some cases, although fund accounting was clearly practised, the transactions of some or all funds were not disclosed, or it was not possible to differentiate between external transactions and transfers:

- four charities did not disclose the transactions through various funds: one stated it was unnecessary and would cause an information overload to users; one that it had been overlooked; one that there was no reason not to disclose the information, there were large movements in those funds and these would be disclosed if the auditors required it; the other that it was being worked on and would eventually be done;
- in one charity it was not possible to determine the difference between internal transfers and external transactions. There was no knowledge of the reason for this;
- one charity separated its fundraising and administrative operations from the performance of its charitable activities. Fundraising and administrative operations were reported in the income and expenditure statement; expenses of its charitable activities were charged against accumulated funds. Fixed asset purchases were also charged against accumulated funds. There was no disclosure of the actual transactions of the accumulated funds account. Instead an appropriation statement, showing planned uses for the funds raised in the current year was published. There was no disclosure of whether the planned activities reported the previous year had actually taken place. It was not possible to reconcile the accumulated funds account;

In addition to the six charities failing to disclose information on transactions passed directly through various funds a number of others presented transfers in such a manner that they could easily be mistaken for income or expenditure related to external sources. The most common problem was with transfers reported inconsistently in that one leg of the entry would be reported as income (or expense), and the other as a clearly differentiated transfer. An example of the confusing nature of such a practice is an organization that sold a major fixed asset. The surplus or deficit on sale of that fixed asset was shown in the accumulated funds account. The sale price of approximately $500,000 was then shown deducted from accumulated funds as a transfer and reported as income of a special fund, but not reported as a transfer. This formed 62% of the net surplus reported for the special funds, giving the appearance of a major surplus for the organization as a whole (see chapter 9 for comments on those auditing fund accounting statements).

The variety of fund accounting practices found and the misleading presentation of some transfers lead to the view that some authoritative guidance in respect of generally accepted accounting practice for fund accounting would be helpful.

7.3.3 Size by Gross Reported Revenue

Gross reported revenue was calculated by adding all reported amounts from external sources whether credited directly to income and expenditure statements, to reserves, to accumulated funds or to special funds. This gross reported revenue includes items that have been classified as capital receipts. Because of the variations among charities in classification of receipts as capital, this method was seen as the only way to derive comparable figures. To calculate these amounts the opening and closing balances of all reserves, accumulated funds or special funds were reconciled with those income and expenditure statements published and all identifiable transfers between funds excluded.

There were variations in the presentation of the financial reports to the extent that it was difficult, and in some cases impossible, to determine the gross revenue of some of the charities surveyed. There is currently no applicable accounting standard that determines a standard method of presentation, however, the exposure draft ED-67: *FRS9: Information to be Disclosed in Financial Statements - A Review of SSAP-9* is intended to apply to all organizations and will require disclosure of gross revenue.

There were some difficulties calculating gross revenue and these difficulties result in a view that some of the figures calculated are understated:

- five charities stated some income figures to be net; it is assumed that those with no such statement have reported gross figures;
- five charities did not disclose transactions directed through specific funds;
- one charity was included in both categories above;

TABLE 7.6
Size by Gross Reported Revenue

Gross Revenue Amount	Number Reporting	%
Less than $500,000	6	18
More than $500,000 and less than $1,000,000	8	23
More than $1,000,000 and less than $2,500,000	9	26
More than $2,500,000 and less than $10,000,000	3	9
More than $10,000,000 and less than $25,000,000	5	15
More than $25,000,000 and less than $50,000,000	2	6
More than $50,000,000 and less than $100,000,000	1	3
TOTAL	34	100

The entity reported on affects the size calculations. Twenty four charities have divisions in other parts of New Zealand. Of those, four presented in their financial reports the whole of their New Zealand operations. The remainder presented financial statements only for the office specified, most commonly the national office. Chapter 8 discusses the concept of the reporting entity and considers the extent of control held by the national organization over these divisions and offices.

During interviews three representatives of charities stated that consolidated financial reports had been produced for their own interest but that these reports are not published. On request one supplied a copy of the consolidated financial report. This would have the effect of moving that organization from the \$2.5 - \$10 million revenue bracket to the \$25 - \$50 million revenue bracket in Table 7.6 above. The revenue reported in the consolidated statements was approximately ten times that reported in the national office statements.

Of the four charities presenting financial statements for the whole of New Zealand:

- one is in the \$2.5 - \$10 million revenue bracket;
- two are in the \$10 - \$25 million revenue bracket;
- one is in the \$50 - \$100 million revenue bracket.

Ten charities disclosed the existence of separate investing or trading entities which commonly hold funds or conduct trading activities and pass income across to the charities. Only one published the financial reports for such an entity and had they been combined with those of the charity itself, the total reported revenue would have not have moved it from \$2.5m - \$10m revenue bracket.

7.3.4 Size by Total Reported Assets

Commonly land and buildings held by charities are carried at historical cost and not revalued. Because some of these organizations have existed for many years the total asset values reported are likely to be far lower than if land and buildings were revalued. Two organizations discussed their decision to regularly revalue their assets and disclosed that this was done because they had encountered financial difficulties and needed to borrow funds.

There were some difficulties in calculating even the historical cost of total assets and these difficulties lead to a view that some of the figures calculated are understated:

- two charities do not capitalize fixed assets; they stated that the funds are no longer there[2]. One of these included fixed asset purchases in the income and expenditure statement but stated that any properties are purchased by an international body then held in trust at nil value by the New Zealand body, the other treats fixed asset purchases as a direct reduction in accumulated funds;
- two charities have a policy of not capitalizing all fixed assets, omitting some under particular circumstances. Both stated their reasons; one being to simplify accounting, the other related to the receipt of some specific funds;
- one charity does not publish a balance sheet, only a statement of receipts and payments. (The reason stated for this was that the organization holds no assets other than bank accounts that were reported, and office equipment that is not);
- one charity which presented twenty six sets of financial statements in some cases capitalizes fixed assets, and in other cases does not. (The reason stated for this is that each "division" sets its own accounting policies).

[2]These two organizations undertake the same type of work and may be considered competitors. Each was aware that the other did not capitalize fixed assets.

TABLE 7.7
Size by Total Reported Assets

Total Assets	Number Reporting	%
Less than $500,000	14	41
More than $500,000 and less than $1,000,000	4	12
More than $1,000,000 and less than $1,500,000	2	6
More than $1,500,000 and less than $2,500,000	1	3
More than $2,500,000 and less than $10,000,000	7	20
More than $10,000,000 and less than $25,000,000	1	3
More than $25,000,000 and less than $50,000,000	2	6
More than $50,000,000 and less than $100,000,000	1	3
More than $100,000,000 and less than $150,000,000	1	3
More than $150,000,000 and less than $200,000,000	1	3
TOTAL	34	100

Again, the entity reported on affects the size calculations. In addition to the four organizations that present financial reports for the whole of their New Zealand operations, one holds and reports the land and buildings for all suborganizations throughout New Zealand, and similarly one reports bank account balances of all branches. For the charity which supplied a copy of consolidated financial reports, size by total assets would move it from the $2.5m - $10m bracket to the $10m - $25m bracket.

Of the four charities presenting financial reports for the whole of their New Zealand operations and the one presenting financial reports including land and buildings for the whole of New Zealand:

- one is in the $2.5 - $10 million bracket
- one is in the $10 - $25 million bracket; and
- one is in the $25 - $50 million bracket;
- one is in the $50 - $100 million bracket;
- one is in the $150 - $200 million bracket.

For the charity which published the financial reports of its investing or trading entity, had they been combined with those of the charity itself, the total assets reported would have not have moved it from $2.5m - $10m bracket. Some of the investing or trading entities have been funded by divestment of assets from the charities concerned. Chapter 8 discusses the concept of the reporting entity and considers the extent of control held by the national organization over these investing or trading entities.

7.3.5 Existence of Basic Financial Statements

All charities published financial statements approximately of the form and title normally expected although one presented twenty six sets of financial statements. Two consisted of receipts and payments statements only, and of the remaining twenty four, thirteen presented a cash flow statement. There appeared to be a number of different preparers of these statements and it was stated that the financial statements are the reports of a number of divisions each of which does its own reporting and decides on its own accounting policies. All of the financial statements together are considered to make up the statements of the national office; they are not the statements for the whole of New Zealand. In the remaining analysis in this section and section 7.3.6 this organization is omitted.

TABLE 7.8
Presentation of Basic Financial Statements

Report	Number presenting	Number not presenting	Total
Balance Sheet	32	1	33
Income and Expenditure Statement	30	3	33
Statement of Receipts and Payments	1	32	33
Statement of Movement of Funds	1	32	33
Statement of Operations	1	32	33
Statement of Cash Flows	16	17	33
Statement of Accounting Policies	30	3	33

Statement of Receipts and Payments

One charity presented only a statement of receipts and payments on the basis that it holds no assets other than bank accounts and office equipment. Its reported gross income was in the \$2.5 - \$10 million range.

Statement of Movement in Funds/ Statement of Operations

The statement of movement of funds and the statement of operations included operating results and then capital expenditure. Neither of these included depreciation in the operating results; one reported capital expenditure net of depreciation, the other showed depreciation as a deduction from accumulated funds. In both cases it was stated that these statements were attempting to show the flow of funds or better mirror reality. It is to be noted that these statements have similarities to the 1993 SORP2 proposed statement of financial activities (CARC, 1993), and that both charities were receiving some influences from the United Kingdom.

Statement of Cash Flows

Seventeen charities failed to provide cashflow statements and reasons given for not providing such a statement were:

- it would confuse users (three);
- the income and expenditure statement is a cashflow statement (three; one of these provided only a receipts and payments statement);
- do not believe in them, or do not think a cash flow statement appropriate (two);
- technically too difficult at the present time (two; both were aiming to provide one in future);
- not aware a cashflow statement was required (two; one of these stated that the financial statements were produced on the basis recommended by a chartered accountant);
- do not know why (five; one of these stated that the latest financial reports released did include a cashflow statement, "a proper audit" having been requested).

The proposals for differential reporting would allow small entities an exemption from a requirement to produce a cashflow statement, although such a statement is encouraged. Of the seventeen charities not providing a cashflow statement, twelve would be exempted under differential reporting proposals because reported revenue is less than $2.5 million and total assets are less than $1.5 million.

Statement of Accounting Policies

Three charities did not provide a statement of accounting policies. One of these presented unaudited financial reports. The other two provided a few comments that were titled notes. All three were the smallest as measured by revenue with each reporting total revenue of less than $100,000. Two were also the smallest as measured by total reported assets and all three reported less than $500,000 of total assets. Two representatives were interviewed and did not know the reasons for this omission.

7.3.6 Existence of Basic Accounting Practices

Some indication was sought to determine whether basic accounting practices existed and whether notes and policies were provided to disclose movements in reserves or funds.

TABLE 7.9
Existence of Basic Accounting Practices

Existence of Basic Accounting Practices	Yes	No	Partially
Fixed assets capitalized	28	3	2
Depreciation charged	25	6	2
Accrual accounting	30	3	0
Clear notes or policies in relation to movements in reserves or funds	12	11	0

Capitalization of Fixed Assets

Three charities did not capitalize fixed assets at all and a further two capitalized some, but not all, fixed assets:

- one presented a receipts and payments statement only and, as is normal with such a statement, included any fixed asset purchases in that statement;
- three showed the purchase of some or all fixed assets in the income and expenditure statement;
- one deducted fixed asset purchases from accumulated reserves.

The reasons given for not capitalizing fixed assets are set out in section 7.3.4.

Depreciation

Six charities did not depreciate fixed assets, and two depreciated some, but not all, fixed assets:

- all three of those mentioned above as not capitalizing fixed assets also obviously do not depreciate them;
- three others capitalize but do not depreciate fixed assets, one of these being small and unaudited, the other two audited. Reasons given by the two that are audited for not depreciating are, for one, that the financial reports are produced by a retired accountant who sees no need; and for the

other, that although the accounting policies state that accrual accounting is observed, some accounting policies are a carry over from old cash based accounting[3].

- Those depreciating some, but not all fixed assets, are the organizations referred to above that capitalize some, but not all fixed assets. One of them, however, capitalizes but does not depreciate buildings. The reason given for this is that there is little justification for depreciating buildings all of which are held at historical cost and worth far more than the balances shown in the balance sheet.

Accrual Accounting

Those charities not practising accrual accounting include the one presenting only a receipts and payments statement, the smallest organization that is not audited, and the one with financial reports prepared by the retired accountant. This latter organization is also in the smallest categories in terms of size calculated by gross reported income and by total assets. In addition to not practising accrual accounting it does not provide a statement of accounting policies.

In some cases, although accounting policies stated that accrual accounting was practised, there were indications that some transactions were not presented on an accrual basis. An example of this is above where a major charity states the accounting policies on depreciation to be a carry over from cash based accounting.

Notes or Policies in Relation to Movements in Reserves or Funds

The difficulties of determining the actual movements in funds are referred to in section 7.3.2. Of the eleven organizations not giving clear notes or policies in relation to movements in reserves or funds, most gave no policy but did give notes. Although it was possible to calculate in most cases what movements took place it was not always possible to work out why. In some cases, when attempting to

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[3]It was stated that fixed assets would in future be depreciated.

derive reasons by observing patterns from year to year, the patterns themselves were inconsistent. One inconsistent pattern appeared consistently to lead to a reduction in reported surplus, however, on inquiry it was stated that this was not the intention.

As an example of a consistent pattern, one organization receiving bequests credited them to a reserve in the year of receipt and transferred them to income the following year. It appeared that decisions were made how to spend bequests at the end of the year and they would reported as income in the following year when they were spent. On inquiry, it was agreed that this was the case and some surprise was expressed that the auditors accepted the practice, however, there had apparently been no comment made.

7.4 EXAMINATION OF AUDIT REPORTS

Thirty three of the thirty four charities stated in their rules that financial statements would be audited. Audit reports were presented for thirty one.

- one stated that the financial reports were audited but could not find the audit report;
- one published unaudited consolidated financial reports but stated that the 30-plus individual financial reports were audited. It was stated that the audit of all subentities is in future to be carried out by one audit firm and that an audit report will then be published with the consolidated financial reports.

7.4.1 True and Fair View Audit Reports

No charity received an adverse audit report although many had a qualification in respect of control over income. This qualification was used in twenty one cases in which two were 'except for' qualifications, and the remainder 'subject to'.

The next most common qualification related to failure to provide a statement of cash flows. Although seventeen charities failed to provide such a statement, two were not audited and one provided a receipts and payments statement only. Of the remaining fourteen charities there were only four audit qualifications for this reason.

Considering that in some cases information was missing and basic accounting policies were not carried out it was somewhat surprising that there were not more auditor qualifications. The audit reports are examined in more depth in Chapter 9.

7.5 SUMMARY

Although there are few reporting and auditing requirements imposed on charities most specify their own requirements in their constitution. They give the impression of an intention to account for resources entrusted to them and to produce audited financial statements. The constitutions also reveal indications of other organizations which may control, be controlled by, or be related to the charity concerned.

Examination of the financial reports of charities shows variations in the entity reported on and some form of fund accounting practised by 53% of the charities surveyed. The variations in fund accounting methods, non-disclosure of some transactions processed directly through particular funds and misleading presentation of transfers lead to the view that it would be helpful if some guidance as to generally accepted accounting practice for fund accounting were given.

The difficulties of presentation, reporting and understanding of fund accounting were observed in the United States in 1975 and were one of the reasons for the recommendations that accounting principles be established for nonprofit organizations. Similar difficulties arose in this research, although presumably those organizations using fund accounting also understand it. Standards of presentation and disclosure require improvement.

Size was calculated for all charities by reported gross revenue and reported total assets. These are crude measures and because of the reporting entity variations and non-disclosure of some transactions are not totally reliable. The sizes are likely to be understated rather than overstated. Based on the information reported, in relation to New Zealand's proposed differential reporting criteria:

- 67% of the charities surveyed report gross revenue below the $2,500,000 threshold;
- 59% of the charities surveyed report total assets below the $1,500,000 threshold.

In selecting the charities to survey the intention was to select larger ones. There must be many hundreds of smaller charities which would be eligible for differential reporting. Notwithstanding the smallness of many charities they would still face the same accounting problems and would have the same, or even greater, need for guidance on such accounting principles and matters such as fund accounting.

The basic financial statements normally expected in a set of financial reports were generally present although the most common omission was the cash flow statement. Two charities presented, in place of an income and expenditure statement, a statement similar to the fund accounting style statement as proposed under SORP2 (CARC, 1993) while one presented a receipts and payments statement.

Generally basic accounting practices were observed although where they were not they did not always appear to be commented on by auditors. It was evident that the non-compliance with accounting standards as observed at such a basic level would be even greater at a more detailed level. The result is likely to be non-comparability of financial reports and non-comparable treatment in funding applications.

The variety of presentations of financial reports of charities lead to the view that it would be helpful to have an accounting standard covering presentation, however, as observed in chapters 3 and 4 it appears that overseas there has been some difficulty establishing a suitable form.

CHAPTER 8

THE REPORTING ENTITY

8.1 INTRODUCTION

"Who is being accounted for? This is always the first question". Ball (1988) used this quote by Tracy (1978) to illustrate his point that defining the reporting entity should be attended to before dealing with deficiencies in reporting practices. He considered the definition of the reporting entity and its boundaries to be neglected despite its fundamental importance in achieving the objectives of decision useful financial reporting.

The fragmentation of nonprofit organizations is common (Bird & Morgan-Jones, 1981; Weinstein, 1978; Holder, 1986; Anthony, 1978). Holder (1986) outlined the ways in which philanthropic and human service organizations may fragment:

- some are "composed of a national organization and numerous local chapters or divisions" (p76);
- some "establish separate legal entities for purposes of (1) fund raising and (2) holding endowment-type resources" (p78).

Wide variations in the extent of the entity reported on were observed by Bird & Morgan-Jones (1981) in relation to charities, and Holder (1986) in relation to nonprofit organizations but especially in philanthropic and human service organizations. Examination of the financial reports and constitutions of charities in New Zealand shows similar variations.

A few charities report on all activities in New Zealand, on the basis that there is only one legal entity. Others issue reports covering only a particular segment of operations; in some cases the segment may be a separate legal entity, in others it is not. As the national offices of charities were approached in this research, the financial reports most commonly received were those of the national office only, each segment or division of operations producing its own separate financial reports.

In addition to this, other variations in the reporting entity were noted:

- a national office reporting only on its own operations but including in its reports properties it holds for the use of all of its divisions;
- a national office reporting only on its own operations but including in its reports the bank balances (but not transactions) of all of its divisions;
- a national office reporting on its own activities and those of all of its divisions but excluding a separate investing entity;
- a charity without separate divisions excluding the trading operations it undertakes;
- a national office reporting on its own activities and excluding a 99% owned company;
- a national office reporting only its own activities by presenting twenty six different sets of financial reports in which different accounting policies were adopted.

The reporting entity concept defines the boundaries of the reporting entity according to the presence of control and this is defined in Australia as:

> The capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in achieving the objectives of the controlling entity. (AARF, SAC1, para 6)

As noted in section 3.12.2 this definition raises the question with respect to charitable organizations, whether existence of control to achieve objectives of the controlling organization is such that the controlling and controlled organizations are one economic entity. The objectives may not be economic ones and the controlling organization may not possess the "power to deploy the resources" of the controlled organization.

This chapter considers the application of various criteria for determining the existence of control. Information was sought from the charities surveyed on the extent of control held over other organizations. The information received is compared with the requirements of SSAP8, and with the reporting entity that would result from the criteria developed by Holder (1986), Ball (1988), and CICA (1993). The comparison is not intended to be exhaustive, but to provide some indication of whether the current standard is appropriate and complied with, and what likely effects there would be if alternative criteria for determining control were adopted. The different criteria lead to the identification of different reporting entities and these are compared.

Two main types of potentially controlled but unconsolidated entities were identified and these are discussed along with the types of transactions occurring between the charities and these entities. The reasons given by the charities for not consolidating these entities in their financial statements are categorized, and conclusions drawn are that in relation to charities there are matters to be considered when setting accounting standards requiring consolidation.

8.2 TYPES OF POTENTIALLY CONTROLLED ENTITIES

It was clear in the financial reports surveyed that a number of charities had potentially controlling relationships with other entities but that these relationships generally were not clearly disclosed. Examination of constitutions and financial reports and interviews with representatives of charities revealed two main types of potentially controlled entities which compare with those Holder (1986) identified:

- investing or trading operations; and
- local divisions, which in some cases may be separate legal entities.

8.2.1 Investing or Trading Entities

Ten charities disclosed the existence of a separate investing or trading entity. There were eight investing entities which invest funds and pass some or all of the income earned to the charity. Two charities disclosed separate trading operations.

One charity published the financial reports of its investing entity with its own, but with the remaining charities it was sometimes difficult to establish from either the financial reports or the constitution that such a separate entity existed. In some cases its existence only became apparent during the interview. Transactions between the charities and investing or trading entities include:

- transfer of some or all net income earned by the investing/trading entity (acknowledged in two cases to be a balancing figure to enable a particular result to be reported);
- management fee charged by the charity to the trading entity;
- divestment of assets from the charity to the investing entity (three);
- bequests received by the charity passed on to the investing entity (two).

8.2.2 Local Divisions

Seventeen of the thirty charities interviewed had local divisions that were not consolidated in the financial reports. The number of divisions identified in this survey ranged from relatively small (fewer than twenty) to relatively large (in excess of 5000). It is common for such multiple divisions of a charity to exist. These are likely to occur on an hierarchical basis with several levels and increasing numbers of smaller divisions moving from a national to a local level. Commonly each level carries some responsibility for the level immediately below (see table 8.1 for an example of a division network).

TABLE 8.1
Division Network of A Charity

Level	Number of Entities
National	1
Regional	21
Sub-Regional	139
Local	396
Specialized Local	1600
TOTAL	2157

Questions about control were asked in relation to all levels of such networks. However, because of the tendency for each level to take some responsibility for the level immediately below, the indications presented in this chapter refer only to the level of the hierarchy immediately next to that of the entity reporting.

Transactions between the national entity and divisions vary:

- transfer of all or a portion of money raised;
- membership fees;
- trading;
- charging of a levy to cover expenses of national entity;
- provision of grants and assistance to divisions.

8.3 INDICATIONS OF CONTROL

Inquiries about potentially controlled entities were made during an interview without prior notice with the aim of receiving candid answers. Two main concerns were expressed when answering:

- lack of certainty as to the correctness of the answers; and
- the difficulty of actually enforcing some of the powers apparently possessed.

The concerns over enforcing powers relate to a tendency among some charities to work on a co-operative, consensus seeking basis irrespective of the legal powers actually possessed. Exercising some powers, other than in extreme circumstances is perceived as self-destructive because retaining volunteers is seen to require their willingness and commitment.

A closer examination would be required before making any decisions about redefining the entities reported on, however, the information received enables identification and consideration of the types of entities, the control able to be imposed on them, and the principles involved. It also allows a comparison between the entities reported on and the reporting entities resulting from:

- application of SSAP8 *Accounting for Business Combinations*;
- application of the criteria indicating control proposed by Ball (1988) and those proposed by Holder (1986);
- application of the criteria proposed in CICA (1993).

Table 8.2 depicts the questions asked of charities and their relevance to determining the extent of control under the different criteria.

TABLE 8.2
Comparison of Criteria Used for Determining Control

Questions for Determining Existence of Control	SSAP8	Ball	Holder	CICA
Selection appointment and removal of management				
Does the potentially controlling organization have the right to approve appointments to the managing or governing body of the subentity?	✓	✓	✓	✓
Does the potentially controlling organization have the right to dismiss members of the managing or governing body of the subentity?	✓	✓		
Power to direct operations				
Are the objects of the sub-entity required to follow those of the potentially controlling organization?		✓	✓	
If the subentity wishes to change its rules is approval of the potentially controlling organization needed?		✓	✓	
Is the potentially controlling organization represented on the managing or governing body of the subentity?		✓	✓	
Could the potentially controlling organization close the sub-entity?		✓	✓	
Financial interdependence				
Does the potentially controlling organization have the power to approve the purchase by the subentity of a major item such as a building[1]?		✓	✓	
If the sub-entity closed would the remaining funds vest in the potentially controlling organization?	✓	✓	✓	
What types of transactions are engaged in between the potentially controlling organization and the sub-entity?	✓	✓	✓	✓

8.3.1 SSAP8 Accounting for Business Combinations

SSAP8 *Accounting for Business Combinations* uses the concept of control to require that "an entity has the power to govern the financial and operating policies of another entity for the purpose of obtaining the benefits and/or assuming the risks normally associated with ownership from its activities" (NZSA, 1993a, SSAP8, para 4.3).

SSAP8 lists a number of criteria indicating power to govern and the obtaining of benefits (see section 5.4.5), stating that any of the factors listed would indicate the existence of power or benefit. These include:

[1] Ball considered that some powers were not mutually exclusive, using as an example the power to approve capital purchases which he considered would also indicate the power to direct operations by controlling the size of operations of a sub-entity.

- indicators of power to govern: power to determine the composition of the board of directors or governing body (without the support of any independent third party); or the power to appoint or remove all or a majority of the directors or the governing members (without the support of any independent third party) (NZSA, 1993a, SSAP8, para 4.4); and
- indicators of power to govern and of benefits: under a statute or an agreement, or any other scheme, arrangement or device, or by the establishment of a trust deed, an entity obtains the majority of the benefits ... (NZSA, 1993a, SSAP8, para 4.4 and 4.5).

8.3.2 Ball and Holder

The criteria Ball (1988) proposed for determining the existence of control covered three broad areas[2]:

- the selection, appointment and removal of management;
- the power to direct operations;
- financial interdependence.

Ball (1988) proposed that the existence of control would be determined by viewing the criteria as a set.

Holder (1986) proposed similar criteria:

- select the governing authority or designate management; and
- influence significantly or control the operations; and
- financial interdependence with the dominant unit usually accountable for fiscal matters.

The difference between the criteria proposed by Ball (1988) and those proposed by Holder (1986) is that, in considering whether control exists, Ball (1988) does not necessarily require all three broad areas to be met although he sees one alone as insufficient. Holder (1986) requires all three criteria to be met.

[2]Detailed examples of the sorts of criteria appropriate for each area are included in Appendix 2.

8.3.3 CICA (1993)

In December 1993 the CICA issued a second exposure draft for the nonprofit sector which included new criteria for determining the existence of control (see table 4.5). These include an initial presumption of control if the right to appoint the majority of board members exists. In the absence of this right control is presumed not to exist, however, that presumption may be overcome by other factors including the extent of any economic beneficial interest and the level of responsibility for the other organization's activities. Although this exposure draft was not available at the time of interviewing charities applicable questions were asked.

8.4 ASSESSMENT OF CONTROL

8.4.1 Investing or Trading Entities

SSAP8 Accounting for Business Combinations

In all ten investing or trading entities income earned is for the benefit of the charity and to be passed across to the charity in some form. In all cases, should these organizations be wound up the remaining funds would vest in the charity. In nine cases the charity possessed the power to appoint or dismiss the governing body, and some concern was expressed by the one not possessing this power that control over the investing entity had been lost. However, in all ten cases there is clearly an arrangement that the charity "obtains the majority of benefits".

Based on these criteria it appears that, under SSAP8, some close consideration of the extent of control able to be exercised is warranted and that probably all ten of these entities should be considered for consolidation in the financial reports of the charities concerned.

Ball and Holder

TABLE 8.3
Extent of Control Over Investing and Trading Sub-Entities

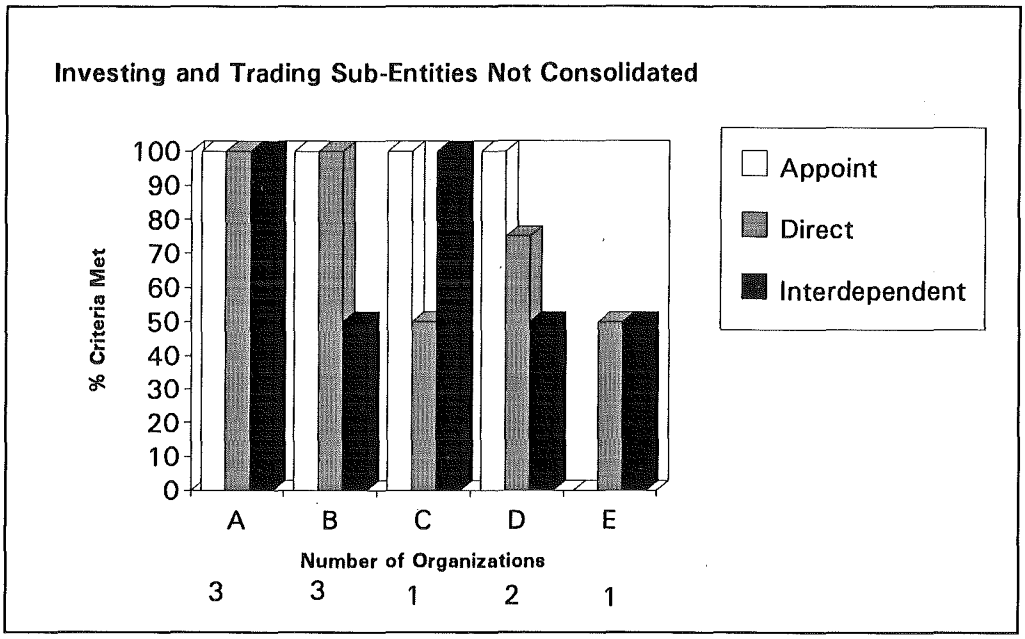

Table 8.3 shows the extent to which the criteria indicating control (the ability to appoint management, direct operations and financial interdependence) are met. Each column has three bars:

- appoint: the power to appoint management was always accompanied by the ability to dismiss, consequently this power either exists at 100% or it is absent;
- direct: there were four questions in respect of the power to direct operations, each positive answer being represented by an increase in the power of 25%;
- interdependent: there were three questions in respect of financial interdependence. The types of transactions engaged in are not depicted but are discussed (see above re SSAP8). For the other two questions each positive answer is represented by an increase of 50%.

Column A represents those entities where all three criteria are fully met. Columns B to E show those entities meeting fewer than all three criteria. Column A, therefore, shows the greatest control; column E the least control. The number of entities is shown below each column.

Three investing or trading entities appear to meet all of the control criteria examined (column A). A further three fully meet the appointment and direction criteria but only one of the two criteria in relation to financial interdependence (column B). In two of these three cases it was stated that although the investing or trading entity did not require permission to purchase a building, such a transaction would not occur as the entity was not established to undertake such transactions. In all cases where financial interdependence is showing as 50%, it is because the charity does not have the power to approve a major capital purchase, although it does in most cases control the composition of the board.

Where the ability to direct operations is less than 100% the most common reason for this was that the ability to close the entity did not exist (three), there was no approval required for a change of rules (two), and the objects were not required to follow those of the charity (one).

Only with the entity in column E of table 8.3 does a significant level of control appear to be in doubt. This is the entity where there is no power to appoint and dismiss the governing body (see SSAP8 analysis above) and some concern was expressed over loss of control of it. However, the transactions occurring between this entity and the charity concerned include the charity passing bequests to it, and the investing entity existing to transfer its net income to the charity. The loss of control relates to control over the timing of receipt of that income. Holder's criteria would lead to a conclusion that it is not controlled because of the lack of power of appointment but Ball's would probably lead to a conclusion that it is.

CICA (1993)

Although the power to appoint or dismiss the governing body was present in only nine cases the Canadian proposal considers that the absence of such a power does not necessarily indicate a lack of control. The existence and significance of an economic beneficial interest is important as well. Where the organization is only able to raise funds and transfer them to the reporting organization, such an interest would indicate control. As noted above, in the case of the investing entity where the power to appoint the governing body does not exist, that entity is receiving bequests passed to it by the reporting organization and all income is for the benefit of the reporting organization. Under Canada's proposed criteria it is likely that all ten investing or trading entities would be considered controlled.

Comparison of the Reporting Entities Resulting from the Application of Different Criteria

For investing or trading entities the criteria in SSAP8 and those proposed by Ball (1988) and CICA (1993) would define the reporting entity in similar ways. Holder's criteria would consider one entity to be not controlled because of inability to appoint the governing body. Table 8.4 compares, in relation to the ten investing or trading entities the number that would be deemed controlled under the various criteria..

TABLE 8.4
Comparison of Control of Investing or Trading Entities

	SSAP8	Ball	Holder	CICA (1993)
Entities likely to be considered controlled	10	10	9	10

Reasons for Not Consolidating Financial Reports

Table 8.5 shows the reasons given by those interviewed for not consolidating the financial reports of the investing or trading entities with those of the charity.

TABLE 8.5
Reasons for Not Consolidating Financial Reports of Investing or Trading Entities with Charity

Reason	Number
Separate legal entity	4
Not considered core business / nature of business different	2
Published with financial reports and few transactions	1
Accidentally omitted	1
Lack of control and would cause accounting difficulties	1
Unknown	1
TOTAL	10

Special Issues

In one case it was stated that the investing entity was established following a special fundraising appeal to raise a capital sum which would be invested and the income only used for the purposes of the charity. Such a sum, whether held by the investing entity or the charity concerned would be subject to external restrictions. Presentation, without clear disclosure, in the financial reports of the charity concerned could lead to the mistaken opinion that the charity had the freedom to dispose of that sum. The existence of external restrictions on the sums held by these entities was not questioned at the time of interviewing, however, in some cases, some of the amounts held may be externally restricted.

A common concern among charities with investing or trading entities is that consolidation would have a negative effect on the charity in that it may be to the detriment of other fundraising activities.

Although such effects are generally considered to be outside the domain of accounting standards setters, these concerns do warrant some discussion as they relate partly to a perceived inability of users to understand financial reports. One of the tenets of the conceptual framework is that a financial report will be decision useful and understandable in that "users might reasonably be expected to comprehend its meaning" (NZSA, 1993c, SC, para 4.5). These concerns are discussed further in Chapter 9 Audit of Financial Reports of Charities, Chapter 10 Perceptions of Charities, and Chapter 11 Perceptions of Funders.

8.4.2 Divisions

There are a number of dictionary definitions of control. The Concise Oxford Dictionary lists one of these as the power of directing or command, and another as the power of constraint. The definitions of control in table 4.4 tend to indicate control in the sense of a power to direct, referring variously to determining and directing policies and dominating decision making. Similarly New Zealand's definition in table 5.1 refers to governing policies. Unlike the investing or trading entities the type of control observed in the divisions appeared commonly to be a power to restrain. This type of control requires consideration when analyzing the responses relating to the divisions.

SSAP8 Accounting for Business Combinations

The power of a national entity to appoint or remove the governing body of a division is more limited than with the investing and trading entities. One national entity possessed the power to appoint and remove the governing body, while a further four possessed the power to remove. SSAP8 considers that either of these powers indicates control, and that such power should exist to enable benefits to be obtained. Of these five, should they be wound up, the remaining funds would vest with the national body. However, there were no arrangements for the national body to receive portions of net surpluses, although one had an arrangement to forward 80% of money raised in the annual public appeal. With this division network the national body possessed only the power to dismiss the governing body and such power was seen as a power of last resort. It was not clear whether the percentage of the national appeal would constitute the "majority of benefits" of the divisions. A number of other transactions between the national bodies and the five division networks occurred, commonly membership fees and trading activities, but these do not seem to be indications of the benefits of ownership. It is possible that closer examination would result in one of these division networks being deemed controlled.

Three other division networks appeared to exist for the purpose of passing money raised to the national entity. With these that national entity had no power in relation to appointment or dismissal of the governing body, however, the benefits involved meet the criteria for control. Consequently all three of these would be deemed controlled.

The criteria in SSAP8 indicate that possibly four of the division networks may be controlled.

Ball and Holder

TABLE 8.6
Extent of Control Over Divisions

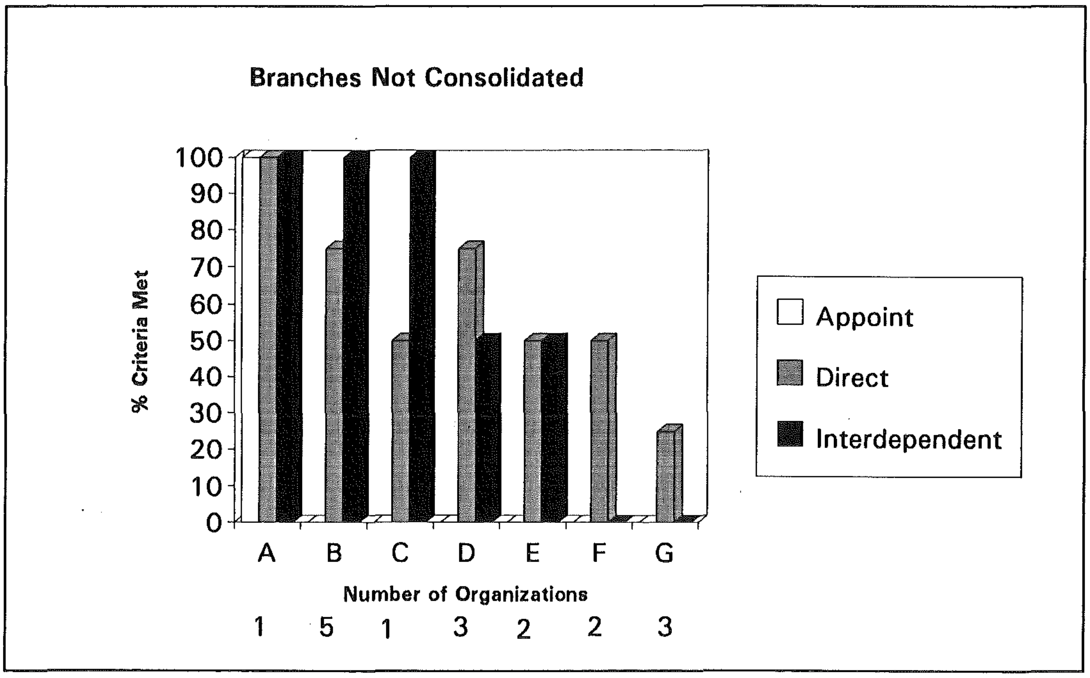

Table 8.6 shows the extent to which Ball's and Holder's criteria indicating control (the ability to appoint management, direct operations and financial interdependence) are met. Each column shows three bars:

- appoint: the power to appoint management was always accompanied by the ability to dismiss, consequently this power either exists at 100% or it is absent;
- direct: there were four questions in respect of the power to direct operations, each positive answer being represented by an increase in the power of 25%;
- interdependent: there were three questions in respect of financial interdependence. The types of transactions engaged in are not depicted but are discussed. For the other two questions each positive answer is represented by an increase of 50%.

Column A represents those entities where all three criteria are fully met. Columns B to G show those entities meeting fewer than all three criteria. Column A, therefore, shows the greatest control; column G the least control. The number of entities is shown below each column.

In directing operations there is commonly power to close organizations or at least withdraw use of the name but, like the power to dismiss the governing body, such power is stated as likely to be exercised only in extreme circumstances. It is rare for the national organization to be represented on the managing or governing bodies of the divisions. Generally the divisions have representation on the governing body of the national organization, this ability to appoint representatives to the governing body working in the opposite way from that envisaged in the control criteria proposed by both Holder (1986) and Ball (1988). This reversal in the flow of control would further weaken the extent to which the national body may control the divisions.

Holder (1986) required the power to select the governing body or to designate management, and this power was to exist alongside all of the other criteria. Using Holder's criteria the absence of the power to appoint would indicate that only one division network, (represented in column A in table 8.6), would be considered controlled. This same network fitted Ball's criteria with the ability to appoint and remove being present.

The remaining organizations do not possess the power to appoint and dismiss the managing or governing body but, using Ball's criteria, this lack of ability would not necessarily mean that control does not exist although it clearly would reduce the likelihood.

Five organizations show a 100% level of financial interdependence but a 75% level in the ability to direct the divisions (column B in table 8.6). In all cases the missing factor is representation on the governing body and, as noted above, this representation is uncommon. Using one of these organizations as an example, although it has no representation on the managing or governing bodies of the divisions and has no right of approval for appointment of those managing or governing bodies it does have the power to:

- dismiss the managing or governing body;
- require the objects of the divisions to follow its own;
- approve any changes of rules;
- close the divisions;
- approve the purchase of any building.

As noted above, some of these powers are more in the nature of power of restraint, however, in addition, it receives 80% of funds raised in the national appeal, membership fees from the divisions, and should the divisions cease to exist, it would receive any remaining assets.

In the five division networks represented in column b the receipt of membership fees is common. Two of the five transfer to the national body a high percentage of money raised in the public appeal, while ine transfers all money raised. Using Ball's criteria there may be reason to consider such divisions controlled.

Column C represents one organization where the ability to direct appears at a 50% level because there is no power to approve changes to rules and, like the others, no representative from the national organization on the governing body of the divisions. Financial interdependence is indicated at 100% and in this organization all money raised is to be forwarded to the national body. The transactions indicate that the divisions of this organization are actually working for the economic benefit of the national body. Although the ability to direct the divisions appears to be lower, and further examination would be warranted, these indications appear to present strong grounds for considering the divisions controlled.

Three organizations are represented in column D. None of these has a representative on the governing body, and neither do they have the right to approve the purchase of a major capital asset, although one stated that consultation would occur. The level of control is reduced but typically these organizations have the power to:

- require the objects of the divisions to follow their own;
- approve any changes of rules;
- close the divisions;

In the event of division closure remaining assets would vest in the national organization and the transactions occurring include trading and, in two cases, membership fees.

Ball's criteria indicate a degree of control and it may be that power to close the divisions would compensate for lack of some of the other powers. As noted earlier, however, this power is seen as one of last resort. It appears that closer examination would be warranted before deciding whether these divisions are controlled.

Column E represents two organizations both with the ability to direct and financial interdependence indicated at 50%. In one of these a function of the divisions is stated to raise and forward money. The amount of money forwarded by divisions was not clear but this organization included in its financial statements the bank balances of the divisions, and this inclusion may indicate that the amounts held by divisions are at least watched.

In the other organization a levy is set at a level to cover expenses and approved campaigns. In this organization income from the divisions is able to be identified in the financial statements and comprises almost 50% of total reported income. It was stated that the levy setting and the governing structure enables the divisions to exert control over the national body by controlling its budget. At this level it would be difficult to assert that the national body possesses much power to control.

The two organizations in column F show only a 50% ability to direct operations. Like the others there is no representation on the governing body; in addition there is no ability to close the divisions. One national body provides support to the divisions by making grants and assists with the funding of regional meetings. The other receives membership fees, those membership fees making up 63% of total reported income of the national organization. Ball (1988) considered the existence of power in one area alone inadequate to enable control to be determined and the indications with these organizations are that they would not be included in the reporting entity.

Column G represents the lowest level of control with three entities showing only a 25% ability to direct operations, all requiring only that objects of the divisions either follow their own or are compatible. In two cases the divisions apply for membership of the national body, and the objectives are required to be compatible for membership to be granted, but the national body has no ability to control changes to those objectives. It was stated that if the objectives were changed to the extent that they were no longer compatible, then discussions over a continuing association would ensue. In these organizations there is some linking for purposes of fundraising, the national body distributing funds raised back to the divisions. In addition some membership fees are charged. Again, as the criteria met relate to only one of the areas Ball (1988) identified these division networks would not be considered controlled.

It appears, using Ball's criteria, that seven division networks, those in columns A, B and C may be controlled.

CICA (1993)

The CICA proposal is that the power to appoint the governing body leads to a presumption of control. In only one division network did such a power exist and consequently this would be considered controlled.

In the absence of the power to appoint the governing body the existence of an economic beneficial interest is an important factor in determining whether control exists. In five cases the division networks have the responsibility to raise funds and forward all or a substantial portion of the funds raised to the national body. In three of those five cases raising and forwarding money to the national body is the total function of the division network. In the other two the arrangement relates only to the annual public appeal and the divisions perform other functions as well. It seems likely under the CICA proposals that these five would also be considered controlled, making a total of six controlled division networks.

Comparison of the Reporting Entities Resulting from the Application of Different Criteria

Unlike the investing or trading entities, application of the various criteria for determining control results in different conclusions. Table 8.7 compares the numbers of division networks likely to be considered controlled, and there is a total of eight networks represented in this table.

TABLE 8.7
Comparison of Control of Divisions

	SSAP8	Ball	Holder	CICA
Entities likely to be considered controlled	4	7	1	6

Table 8.8 further analyzes the control in these networks discussing the differences between them.

TABLE 8.8
Analysis of Control of Divisions

Reason for difference	SSAP8	Ball	Holder	CICA
a) Economic benefit and no power to appoint or remove managing body	3	3	0	4
b) Economic benefit and power to remove but not appoint managing body	1	1	0	1
c) No economic benefit, and power to remove but not appoint	0	2	0	0
d) No economic benefit, and power to appoint	0	1	1	1
TOTAL	4	7	1	6

SSAP8 requires the power to appoint or remove the managing body in order to receive economic benefits, while Holder, who is much more restrictive, requires in all instances the power to appoint the managing body. Consequently for those entities depicted in row a, although there may be economic benefits received, the lack of power to appoint or remove means that division networks considered controlled under Ball's, the CICA and SSAP8 criteria would not be considered controlled under Holder's criteria. However, the CICA criteria do not require the majority of benefits to flow to the controlling entity and it appears likely that these criteria would judge control to exist in one division network more than would SSAP8.

In row b lack of ability to appoint the governing body would lead, under Holder's criteria, to a decision that such a division network is not controlled.

Row c demonstrates the use of Ball's criteria in the absence of an overall requirement for economic benefit. There is no economic benefit to be gained by the national bodies and neither do they have the power to appoint the managing body of the divisions. However, the other powers possessed, which in some cases appear to be restraining powers, together with a level of financial interrelatedness may lead to a conclusion that these division networks are controlled. As already observed, the type of control involved requires consideration and questions may be asked whether in this case the national body has sufficient power to operate the whole division network as one economic entity, or whether the power it possesses is one which enables the noneconomic objectives of the organization to be carried out.

Row d demonstrates the power to appoint the managing body and a high level of financial interdependence without economic benefit flowing back to the national organization. In this instance under SSAP8 it may be concluded that control does not exist because of the lack of economic benefit.

Liabilities

Further consideration of control may be necessary. SSAP8 considers the "guaranteeing of substantially all of the liabilities or other obligations of another entity" (SSAP8, para 4.4) to be an indication of the power to govern the financial and operating policies of that entity. The significance of this paragraph was not appreciated until after the interviews were conducted and hence this was omitted in interviewing representatives of charities. However, in all division networks where the divisions are not separate legal entities it seems likely that the national entity is undertaking such risks. This is specified in SORP2 (CARC, 1993) which states that divisions that are not separate legal entities are considered to be controlled. In Canada such a situation is also an indicator of control (CICA, 1993).

Although it appears that only four of the division networks meet the control criteria specified in SSAP8 in relation to controlling the governing body and receiving the benefits associated with ownership, in eleven instances they appear to be a part of the legal entity formed by the national body. Consequently it appears likely that the national body is effectively guaranteeing any obligations assumed by the divisions and therefore that those division networks would be considered controlled under SSAP8.

Ball included in his criteria indicative of financial interdependence the responsibility for long term debt, while Holder (1986) stated that the dominant entity should be accountable for fiscal matters. If the lack of separate legal status for the divisions can be considered to meet these criteria then the legal status of the divisions would require consideration when establishing the existence of control.

Holder requires all three criteria to be met so lack of separate legal status would not increase the number of division entities requiring consolidation because of the lack of ability to control the composition of the governing body[3].

Using Ball's criteria, lack of separate legal status appears to increase financial interdependence. Predominantly the unincorporated divisions occur at a higher

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[3]Holder did not discuss such a situation. He appeared consider all the organizations he surveyed to be separate legal entities.

level of control. In columns a to c of table 8.5 where the division networks appear to be controlled, all seven lack separate legal status. In colums d and e where control appeared doubtful three of the five division networks lack the separate legal status, two occurring in column d and one in column e. In column d especially, this increase in financial interdependence may lead to the view that the two charities concerned do have control over their division networks. In column g, where it was concluded that control did not exist, the division network of one charity lacks separate legal status.

Ball's criteria may lead to the addition of two further division entities, those in column d to the seven previously considered likely to be controlled. Table 8.9 compares the number of division networks likely to be considered controlled taking lack of separate legal status into account. There is a total of eleven networks represented in this table with those deemed controlled using Ball's and Holder's criteria a subset of the others.

TABLE 8.9

Comparison of Control of Divisions Incorporating Lack of Separate Legal Status

	SSAP8	Ball	Holder	CICA
Entities likely to be considered controlled	11	9	1	11

Table 8.10 analyzes these further.

TABLE 8.10
Analysis of Control of Divisions Including Lack of Separate Legal Status

Reason for difference	SSAP8	Ball	Holder	CICA
a) Economic benefit and no power to appoint or remove managing body	3	3	0	4
b) Economic benefit and power to remove but not appoint managing body	1	1	0	1
c) No economic benefit, and power to remove but not appoint	0	2	0	0
d) No economic benefit, and power to appoint	0	1	1	1
e) No economic benefit, no power to appoint or remove	7	2	0	3
TOTAL	11	9	1	11

Reasons for Not Consolidating Financial Reports

TABLE 8.11
Reasons for Not Consolidating Financial Reports of Divisions with Charity

Reason	Number
Considered autonomous	8
Major accounting difficulties envisaged, large number of entities involved following varying accounting practices, and timeliness of financial reporting would be affected	5
Lack of control (one also stated small amounts involved)	2
Separate legal entity	1
Unknown	1
TOTAL	17

Special Issues

Five charities cited major accounting difficulties as reasons for not consolidating the financial reports of division networks. These difficulties include the large number of entities involved, the varying accounting practices adopted at different levels in the organization, the likely delay in financial reporting and the need to obtain co-operation rather than merely issuing orders. These difficulties are not trivial.

In particular although legal control may exist, enforcing that control can be self-destructive at times. An example of the difficulties of such enforcement is of divisions reacting badly against attempts to incorporate their records into those of the national body through concern that "their funds" would be taken[4]. Another example of difficulties enforcing legal powers is of the Lifeline organization in Christchurch in 1993 where a number of former volunteers of that organization established a breakaway organization as a result of strain between volunteer and paid staff and attempts made to impose controls.

It must also be noted that those organizations providing consolidated financial reports of their division networks have undertaken reorganization and rationalization of those division networks and employ paid staff at strategic points in those networks. This is not necessarily the case in other division networks. As has been found by one of the charities producing consolidated financial reports, achieving audited consolidated financial reports is a further hurdle.

Table 8.1 gave an example of the type of division network in operation in those charities with large numbers of divisions. These divisions may, or may not, be a part of the single legal entity formed by the national body. Typically, in such an organization, the major transactions are likely to be carried out at the national and regional levels. Below those levels the numbers of divisions increase, the amounts being dealt with decrease, and practical problems proliferate in respect of co-ordinating and standardizing methods in order to have any possibility of achieving a task such as consolidation of all financial reports. If a decision is made that divisions are controlled, questions of materiality would require consideration in any requirement to consolidate financial reports.

SORP2 acknowledges the difficulties of trying to consolidate the financial reports of a large division network. It proposes that only large charities should do

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[4]Interview 28 October.

so. It defines large charities to be those that meet two of three criteria (CARC, 1993):

- gross resources (includes intra group transactions) arising in the year exceeding £13,440,000 or net resources arising exceeding £11,200,000;
- gross £6,720,000 (including intra group balances) aggregate balance sheet total or £5,600,000 net balance sheet total;
- group employment of more than 250 persons.

SORP2 proposes that where charities are not large in terms of the criteria proposed, then the reporting required is as for connected charities (or related parties). New Zealand's differential reporting proposals have a relatively low threshold and could be quite harsh on charities with division networks.

A further issue requiring consideration is whether a part of a legal entity may be uncontrolled, or whether the legal entity is the smallest unit for general purpose financial reports. As has been noted in SSAP8 "the existence of control is a function of substance rather than form" (NZSA, 1993a, SSAP8, para 4.8). Commonly, in relation to controlled organizations, this application of substance over form has been used to identify the relationship existing between separate legal entities in order to decide whether they should be reported as one. In relation to charities, the form of the arrangement is that some division networks are a part of one legal entity. The substance of the relationship, however, may indicate that such divisions are not necessarily controlled[5]. Although SSAP8 may define them as controlled, Ball's criteria consider the responsibility for debt to be only one of the criteria to be viewed as a set.

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[5]An auditor observed such lack of control, noting that attempts by a national body of a nonprofit organization to consolidate the financial reports of its branches, which were not separate legal entities, brought threats from some branches that any attempts to take their money would result in there being nothing to take as the branches would ensure it was all spent. (Interview 28 October)

8.5 AFTER DEFINING THE REPORTING ENTITY

Where a level of control exists but is inadequate to determine that entities are controlled consideration should be given to related party disclosures. Related party disclosures require the existence of significant influence.

Three related party disclosures were made.

- one organization stated that its divisions were separate legal entities and that they were not related;
- one organization stated the relationship with its divisions and the types of transactions occurring between the divisions and the national body;
- the organization with twenty six different financial reports acknowledged the existence of related parties in seventeen of them.

SORP2 (CARC, 1993) refers to connected charities which are identified not by control or significant influence but by common trustees, unity of administration, common, parallel or related objects and activities. SORP2 recommends that such connected charities make disclosures similar to those required where related parties exist.

Charities are typified by a co-operative approach. Concepts of control or significant influence will not necessarily result in an indication, if such an indication is required, of the number of organizations co-operating to achieve particular objectives. These organizations could be using the same or very similar names.

8.6 SUMMARY

The boundaries of the reporting entity are defined by the existence of control. Australia's reporting entity concept defines control in such a manner that entities subject to control to achieve the objectives of the controlling entity are deemed to be one economic entity. Although this may be true of businesses where economic objectives may reign, in the case of charities the objectives may not be economic. The control able to be exerted may be sufficient to enable the achievement of non-economic objectives without economic control existing. In such a situation it would be illogical to consider the group of entities as one economic entity.

The fragmentation of charities results in two main types of potentially controlled entities:

- investing or trading entities; and
- division networks.

Investing or trading entities operate in such a manner that SSAP8 clearly applies. All ten of those examined appear to be controlled. Application of the alternative criteria proposed by Holder (1986), Ball (1988) and CICA (1993) result in a similar decision.

Division networks, however, operate differently in that the powers possessed by the national entity appear to be more in the nature of restraint than positive domination and although connected with the national entity they do not necessarily operate to provide that entity with "the benefits ... normally associated with ownership" (NZSA, 1992, SSAP8, para 4.3). There are some division networks that do operate simply to raise and forward money to the national entity. They appear to be controlled in a sense that consolidated financial reports would be meaningful and all criteria except for Holder's identify them as such.

More commonly division networks co-operate with the national body and other divisions to fulfil non-economic objectives. Any decision that they are controlled and should, therefore, prepare consolidated financial reports leads to an assumption that they operate as one economic unit with the controlling entity possessing economic power over them. This is not necessarily the case and such division networks could be more appropriately reported as connected rather than controlled.

It may be that lack of supervision of charities in New Zealand (see section 5.6.3) has contributed to the situation where a number of charities appear to have lost a degree of control of parts of their legal entity. To the extent that those divisions incur liabilities legal action to enforce them would probably be taken against the national legal entity. Some of these national entities include in their constitutions a stipulation that permission is required to incur liabilities, however, there is clearly a potential for liability. The criteria in SSAP8 and CICA (1993) indicate that such entities should be considered controlled and financial reports consolidated. Ball (1988) and Holder (1986) refer to the liability involved as merely one of the factors to be taken into account in deciding whether control exists[6]. Given the comments above about the ability of the national entity to deploy the resources reported in consolidated financial reports, even where the division networks are not separate legal entities, the usefulness of consolidated financial reports may be questioned (see chapter 9).

Any decision that division networks are controlled and the financial reports should therefore be consolidated would require consideration of practicalities and cost benefit factors. The SORP2 approach where a high differential threshold is proposed would be essential to provide some relief from the major task of standardizing and co-ordinating reporting practices and the costs of auditing. There would also be some need to consider materiality in respect of any requirement to consolidate the financial reports of very small entities.

Currently absence of control as defined in SSAP8 *Accounting for Business Combinations* results in consideration of whether significant influence exists thus requiring related party disclosures. SORP2 refers instead to connected charities

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[6]Holder did not appear to consider the possibility that parts of a legal entity were omitted.

identifying them by objects and activities. If some indication of the extent of division networks is considered useful in financial reports, modification of SSAP22 *Related Party Disclosures* is necessary.

There appears to be little attention paid by charities or their auditors to controlled and connected charities. The title of SSAP8 refers only to business entities and may perhaps be a factor in this oversight. A further factor may be that clarification to the catch-all paragraphs 4.4 and 4.5 is required. However, in respect of investing or trading activities, all of which appear to be controlled under SSAP8, their omission from the financial reports of the charities is cause for concern. In some cases the true operations and financial position of the charity are likely to have been misrepresented. This is considered further in chapter 9 in the examination of audit reports.

CHAPTER 9

AUDITS OF FINANCIAL REPORTS OF CHARITIES

9.1 INTRODUCTION

Chapter 4.5 noted that researchers overseas had found financial reports of charities were being issued with unqualified audit opinions yet those financial reports did not comply with accounting standards. Some of the possible reasons for this have related to low perceived risk, inadequate fees, allocation of charity audits around the partners of the firm, the use of lesser qualified staff and the avoidance of problems. Audit guides are now available in the United States, United Kingdom and Canada, with one being prepared in Australia.

The 1984 research report in New Zealand (Dixon & Rees, 1984) also issued a reminder that auditing standards should be followed and this has been repeated more recently.

As outlined in chapter 7, of the thirty four charities that took part in the research thirty three stated in their rules that financial statements would be audited. Audit reports were received from thirty one. In respect of the remaining two charities:

- the financial reports of one charity were stated to be audited but the audit report was not provided and could not be found;

- unaudited consolidated financial reports were published by one charity but the 30-plus individual financial reports, which were not published were audited[1].

One of the charities provided twenty four audit reports for its twenty six sets of financial reports. For analysis purposes this charity will be omitted, as will the one publishing a receipts and payments statement audited as such. The audit reports and financial reports of the remaining twenty nine charities will be examined.

The auditors of these twenty nine charities were all members of the New Zealand Society of Accountants. For analysis, the audit reports issued have been categorized into two classes: "big six" and other. Based on the gross reported revenue and total reported assets classifications used in chapter 7, five of the thirteen charities audited by the "big six" firms are larger than the proposed size criteria for differential reporting as are three of the sixteen audited by the other auditors.

In this chapter the audit reports and the qualifications contained in them are examined. The number of qualifications in those audit reports are compared with the number of times that basic financial statements were omitted or accounting practices clearly not followed.

A "true and fair view" audit report involves an assumption that acceptable accounting principles have been applied. As noted in chapter 7 there are no accounting standards in New Zealand which deal with fund accounting. More than half of the charities were clearly practising some form of fund accounting and there were a variety of methods of presentation. The steps involved in determining that a

[1] It was stated that the audit of all subentities is in future to be carried out by one audit firm and then the consolidated financial reports will be audited.

"true and fair view" is depicted are outlined and compared with the variety of fund accounting practices and the audit reports.

As observed in chapter 8 there are two types of entities possibly controlled by charities; investing and/or trading entities and branches. The investing and/or trading entities in most cases have the appearance of meeting the criteria for control as set out in SSAP8 yet none were consolidated in the financial reports and neither were there related party disclosures. These omissions are compared with the audit reports.

Three auditors were interviewed to determine any differences, where they occur, in conducting honorary and semi-honorary audits. Their perspectives when auditing charities are outlined.

9.2 TRUE AND FAIR VIEW AUDIT REPORTS

Examination of the audit reports shows that all auditors expressed the opinion that the financial reports present a true and fair view of the financial position and of the results of financial operations. Three used the term "fairly present", and the most common qualification to audit reports related to control over income; this qualification being used twenty times. Two of these were "except for" qualifications, and the remainder "subject to".

The financial reports were examined for existence of:

- all expected reports; income and expenditure statement, balance sheet, cash flow statement, statement of accounting policies; and
- basic accounting practices: accrual accounting, capitalization of fixed assets, depreciation of fixed assets.

The audit qualifications to these financial reports are set out in table 9.1.

TABLE 9.1
Failures Observed in Audited Financial Reports

	Big Six	Other	Total
Failure to Provide Statement of Cash Flow			
Number of Qualifications	4	0	4
Number of observations of failure to provide a cash flow statement	5	9	14
Failure to Provide Statement of Accounting Policies			
Number of Qualifications	0	0	0
Number of observations of failure to provide a statement of accounting policies	0	2	2
Failure to Capitalize some or all Fixed Assets			
Number of Qualifications	0	0	0
Number of stated occurrences	3	1	4
Failure to Depreciate Capitalized Fixed Assets			
Number of Qualifications	2	0	2
Number of occurrences	2	1	3
Clear Failure to Practice Accrual Accounting			
Number of Qualifications	0	0	0
Number of Occurrences	0	1	1
Total			
Number of Qualifications	6	0	6
Number of Occurrences	10	14	24

In chapter 7 those charities not providing a statement of cashflow were analyzed by the size criteria proposed for differential reporting. A similar analysis in respect of audit qualifications shows that the charity audited by a "big six" firm which did not receive a qualification for failure to provide a statement of cashflow would not be required to produce one under the proposed differential reporting regime. Eight of the nine audited by "others" would also not be required to produce a statement of cashflow under the proposed regime.

One charity did not provide a statement of cash flow or a statement of accounting policies and did not depreciate fixed assets or practice accrual accounting. In the classifications of size based on gross reported income (table 7.5) and total reported assets (table 7.6) this charity is included in the smallest category in both cases. It received, from a member of the Society in public practice, a true and fair view audit report qualified only for control over income. It was stated during the interview with a representative of this charity that a letter had recently been received from that practitioner advising that following a peer review conducted by the New Zealand Society of Accountants, changes would be necessary.

After the relatively frequent failure to qualify financial reports lacking a statement of cash flow the next most common failure related to those charities not capitalizing some, or all, fixed assets. One auditor, of charity that does not capitalize any fixed assets stated that this practice had been debated with representatives of the charity concerned[2]. It had recently been realised that there was no qualification in the audit report, and the omission was described as an oversight. The auditor stated that for financial reports having a wide circulation, such as those of listed companies, disclosure was taken very seriously with a special check carried out. For smaller organizations, with less likelihood of a wide circulation for financial reports, presentation and disclosure was seen as being of less importance. Although checks were made the special check was not normally carried out in such circumstances and consequently such an omission was feasible[3].

Although some failures to observe basic accounting practices appeared to be noted by auditors, in discussion with one auditor it was acknowledged that some charities state a policy of accrual accounting but either do not do so, or carry out only the most basic accruals. It was possible to detect total failure to observe

[2]The debate had also been acknowledged by a representative of the charity.

[3]Interview 10 November.

accrual accounting, but not a partial failure. Two auditors commented that charities seem to regard accounting standards as not applying to them. One called for some emphasis from the New Zealand Society of Accountants that general accounting principles do apply.

In respect of the failures to provide financial statements and to observe basic accounting practices the "big six" firms qualified financial reports six times out of the ten occurrences observed. The "other" auditors, however, did not qualify financial reports at all despite fourteen occurrences of such failures[4]. These comparisons were carried out at a fundamental level. Were they to be carried out in more depth, there was every indication that material failures would not be commented on by auditors.

In addition to audit reports in respect of the basic matters referred to above there were two further "subject to" qualifications:

- reliance on another auditor;
- whether the charity was a going concern[5].

There were four further "except for" qualifications all of which related to one charity:

- failure to revalue investment properties;
- failure to provide segment reporting;
- non-disclosure of movements in special funds;

[4]Four occurrences related to one practitioner in respect of the financial reports of one charity.

[5]The charity involved was observing accounting practices it disagreed with. It had been donated major fixed assets which had been valued and brought into the financial reports. The recognition of depreciation on the donated fixed assets was resulting in deficits being reported and a negative balance in the general fund. Disagreement was expressed with accounting practices requiring depreciation of donated fixed assets. This view has been argued at length in the United States.

- transactions credited directly to special funds without first being disclosed in the income and expenditure statement.

Additional qualifications on the reports of this charity included a limitation of scope, failure to depreciate buildings and failure to provide a statement of cash flows; the latter two are included in table 9.1. There was no quantification of the financial effects of any of these failures and this was because of impracticability and lack of information. Despite the number of qualifications and lack of quantification of the financial effects the audit report stated that the financial reports fairly presented the financial position and results of operations. Under the circumstances one must wonder how such a conclusion could be drawn.

These qualifications were included for the first time in the most recent financial statements. No apparent changes in accounting policies had been made and there was a history of issuing audit reports qualified only for a limitation of scope. Discussion with the auditor revealed a change in partner involved in the audit, a concern that funding organizations may be misled by the financial reports, and some history of recommendations for improvements in financial reporting[6].

9.3 AUDIT STANDARDS AND FUND ACCOUNTING

There were a number of variations in presentation of financial statements and it was difficult, sometimes impossible, to establish a gross income figure. This was particularly a problem with fund accounting, either because not all movements in funds were disclosed or because of difficulty or impossibility differentiating between internal transfers and external transactions.

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[6]The history of recommendations had been acknowledged by a representative of the charity concerned.

Auditing Standards and Explanatory Notes (NZSA, 1993e, p89) state that a true and fair view implies "consistent application of acceptable accounting principles", such acceptable accounting principles implying:

> that all relevant Statements of Standard Accounting Practice (SSAPs) have been complied with (except where compliance would give a misleading view); and
>
> that any accounting policies which are not the subject of SSAPs are appropriate to the circumstances of the entity and have substantial authoritative support.

It is not clear exactly what is considered to be authoritative support in the context of the auditing standards and guidelines, but it is discussed in *Explanatory Foreword to General Purpose Financial Reporting* (NZSA, 1993f, para 4.3).

Fund accounting appears to be ignored by the accounting profession in New Zealand, with no exposure drafts, interpretations or research bulletins having been published. Consequently, for the auditors of those charities practising fund accounting, authoritative support is likely to derive from international or other sources. Table 9.2 shows the main difficulties encountered with fund accounting statements.

TABLE 9.2
Audit Reports and Fund Accounting

	Big 6	Other	Total
Failure to Disclose Movements in Funds			
Number of Qualifications	1	0	1
Number of Occurrences	3	2	5
Lack of Clarity Disclosing Movements in Funds			
Number of Qualifications	0	0	0
Number of Occurrences	3	0	3
Total			
Number of Qualifications	1	0	1
Number of Failures	6	2	8

There were eight out of twenty nine charities where it was either impossible, or very difficult to discern the transactions passed directly through particular funds. In five cases there was no disclosure whatsoever, and in a further three it was impossible or very difficult to differentiate between internal transfers and external transactions.

Only one audit report included a qualification in respect of fund accounting. This stated that amounts credited and debited directly to funds should have been directed through the income and expenditure account in the first instance and that there was a failure to disclose movements in funds. The basis for these qualifications was that those practices were not generally accepted. The authoritative source for this qualification was stated to be the commercial environment[7].

In one charity where the movements were not disclosed a considerable amount of time was spent attempting to identify them using an incomplete records approach. A statement of cashflows may have been helpful, but this was not provided on the basis that it was considered likely to be confusing to users. This organization showed its fundraising and administrative transactions in the income and expenditure statement and provided a statement of projected allocations for the uses of the funds raised. These projected uses included both charitable activities and fixed asset purchases and were in the range of $600,000 to $1,400,000 each year. However, there was no disclosure of the actual sums spent. The auditor concerned stated that it had not been realized this lack of disclosure was occurring. In other charities where there was no disclosure of movements, there was insufficient information to even attempt to estimate the amounts being directed through the funds.

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[7]Interview 28 October.

As noted in chapter 7, in one charity where movements in funds were unclear a $500,000 transfer from accumulated reserves was presented as income of a particular fund. The auditor of this charity when asked about this transfer outlined the history to it, noting a difficulty with transfers between funds[8] and suggesting that those organizations practising fund accounting should aim for comprehensive financial statements.

Audit standards state that where there is no accounting standard for a particular accounting practice there should be authoritative support for that practice (NZSA, 1993e). In the only instance where an auditor did qualify the audit report in respect of a fund accounting practice the justification related to commercial practices rather than authoritative sources on fund accounting. Although there appears to be no New Zealand derived authoritative support for fund accounting, there are other sources. These seem to have been overlooked with the result that in some cases the presentation of financial reports obscures or fails to disclose aspects of the operations of the charities concerned.

9.4 AUDITING AND THE REPORTING ENTITY

Variations in the entity being reported on were discussed in chapter 8, and numerous variations in the reporting entity were observed. If the boundaries of the reporting entity are not clearly identified misreporting is an obvious consequence (Ball, 1988).

Two types of possibly controlled entities were identified in chapter 8, these being investing or trading entities and branch networks. The conclusions drawn from a superficial examination of the relationship between these entities and the

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[8]Interview 21 October.

charities concerned were that the investing or trading entities appeared to be controlled under the criteria in SSAP8.

The apparent control between the charities and the investing or trading entities was most consistent with the control likely to be found between any business oriented parent organization and its subsidiary: there was a level of ability to control the composition of the governing body, and profits earned by the investing or trading entity were for the benefit of the charity and likely to be passed on to it. In addition, some of these entities were funded by the divestment of assets from the charity, or by the transfer of a portion of the income of the charity (some or all bequests or surplus funds). None of the financial reports of the investing or trading entities were consolidated with those of the charity concerned.

There were ten of these investing or trading entities and if they were not controlled[9], then they were very clearly related parties. There was one disclosure stating that the charity concerned was the sole trustee of the investing entity and that the financial statements of that entity were attached. This disclosure does not meet related party disclosure requirements. The amount transferred from the investing entity to the charity is clear in the financial reports. It is not clear, however, that a portion of the charity's income had been passed to the investing entity. That income also appeared not to have been disclosed in the financial reports of the charity.

Another charity published unaudited consolidated financial reports which excluded the investing or trading entity, but provided during the interview a copy of the audited financial reports for the national office. These financial reports will

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[9]One is a company of which 99% of the shares are owned by the charity.

be referred to in examining the audit reports of the ten investing or trading entities. Table 9.3 relates the investing or trading entities to the auditors.

TABLE 9.3
Audit Reports and Controlled or Related Entities

	Big 6	Other	Total
Existence of Controlled or Related Investing or Trading Entities			
Number of Qualifications	0	0	0
Number of Occurrences	5	5	10

The question of existence of control over these investing or trading entities appeared to be overlooked during audit of the financial reports of the charities even though it seems that at least in some cases the auditors may have involvement in the audit of such entities. The financial reports of three of these entities were sighted and this was the case in all three instances. It is to be noted, however, that the latest financial reports of the charity which has a 99% owned company were qualified for failure to comply with SSAP8[10].

The question of investing or trading entities was discussed with two auditors. One, an auditor of one of the charities with such an entity, acknowledged overlooking the possibility that such an entity may be controlled by the charity and stated that if the entity were controlled[11] it would be preferable to publish the financial statements with those of the charity rather than to consolidate them. The reason for this related to a perceived inability of users, especially major funding

[10]These financial reports were provided at the interview and were stated to be an improvement over previous years, a "proper audit" having been requested. In addition to the qualification for failure to comply with SSAP8, these financial reports contained a statement of cashflows which had not been provided in the past.

[11]With this particular investing entity, information received from the charity interview in relation to transactions between it and the charity was that there had been no divestment of charity funds and neither was any of the charity's income diverted to it.

agencies, to understand financial reports. The other auditor, in relation to other charities he audits, observed a tendency to establish investing entities and disagreed with it. This latter auditor noted, however, that wealth reported in financial reports appeared to be an impediment to fundraising.

The third auditor observed the need to identify relationships among charities and that related organizations can be a complication with charity audits.

9.5 VIEWS OF AUDITORS

Three auditors were interviewed and all three were partners of "big six" firms. The auditors were chosen to enable particular questions to be raised about financial reports of client charities. Their comments in respect of their client charities have been included in the earlier sections of this chapter.

The auditors were also asked about auditing charities generally. All three stated that there were no major differences between the financial records kept by a charity and those kept by a company. There was, however, a differential basis in charging for a charity audit with reduced or no fees charged. Two acknowledged some differences in carrying out a charity audit as compared with that of a company.

One disclosed a difference in allocation of fee paying and honorary audits in that a group of six staff would conduct all of the fee-paying charity audits but the honorary audits were spread around the staff. The planning document for an honorary audit was likely to be less comprehensive and the audit would be carried out by more junior staff than would be the case for a fee-paying audit. It was stated that an honorary audit was "not just ticking" and there was no difference in the review procedure although the papers for review would be different. Those for an honorary audit were likely to be one page of handwritten notes, while those for a fee-paying audit were likely to be more detailed. There would be a clearance questionnaire and the audit would be signed off by a partner. "I would like to think that the audit is not less comprehensive. It depends on whether we have planned and identified where problem areas are". Management letters were stated to be provided in all cases although an honorary audit may receive only a couple of paragraphs. Where fees were charged for charity audits they tended to be discounted.

The other auditor acknowledged a "more relaxed view" in relation to honorary or semi-honorary audits. He did, however, observe a danger with such audits that standards could slip. The more relaxed view was connected to the risk analysis undertaken and narrow circulation of the financial reports would affect that risk analysis[12]. There would be a written planning document identifying key risk areas and this would not be expected to change much from year to year. It was observed that charity operations were likely to be stable and that this stability would help with risk assessments. Staffing of charity audits would mostly be delegated to more junior staff members with an audit requiring two staff likely to be carried out by a graduate with a second year staff member as senior. This staffing allocation was different from that likely with a company paying full fees in that a third year staff member would be the senior.

The audit review was stated to be no different from that for any other organization and a management letter provided but the fee, if charged, would be discounted. Honorary audits were stated to provide good on the job training and to sometimes provide business contacts.

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[12]He stated that he did not know the circulation of the financial reports of the client charity (see chapter 10 for distribution of financial reports).

All three auditors were asked if there were any accounting standards that should not be applicable to charities. They considered there to be none but one called for realism in respect of requiring statements of cash flow, while another observed problems applying this standard. Cash flows were stated to be difficult to reconcile because of "transactions flying around different reserves." One stated some difficulty in respect of extraordinary items and income that tended to be viewed by some organizations as a direct addition to capital.

All three commented on difficulties in relation to fund accounting or restricted income. One stated that funds are often presented separately and considered this to be messier with auditors normally accustomed to dealing with "one profit and loss account". Another acknowledged fund accounting as a difficult area but saw good reason for keeping restricted funds separate from unrestricted funds. He described transfers between funds as "a nonsense" because restrictions were often self-imposed. He considered that those organizations using fund accounting should present comprehensive financial reports. The third, who had referred to "transactions flying around different reserves" noted that charities may wish to carry out such transfers "above the line to reduce problems of subsidization". He expressed concern at the lack of understanding of those reading financial reports, particularly those in government departments "who look at bald figures. Do those evaluating financial reports have the knowledge?"

The auditors were asked whether they considered the financial reports of charities likely to have any effect on their ability to raise funds. Two thought they would have an effect, with one observing the establishment of investing entities to take wealth off the balance sheet. The other considered a barrier to consolidating the financial reports of a branch network to be that those consolidated reports may result in the organization being seen as wealthy. For the same reason he also stated a preference not to require the financial reports of a controlled investing entity to be consolidated. The third auditor considered financial reports likely to have only a limited effect and stated that he had never been involved in any debate over presentation, disclosure and accounting standards[13].

9.6 SUMMARY

An analysis of audit reports of twenty nine charities showed that no charity received an adverse audit report. In respect of the provision of particular financial statements and basic accounting practices there were failures to qualify the reports although "big six" accounting firms noted some failures while the other auditors did not. This analysis was conducted at a basic level but the indications were that an in depth analysis would result in finding other material failures.

Interviews with charities brought disclosures in respect of ten investing or trading entities. There was evidence of control of these entities as defined in SSAP8. Although auditors were involved in the audit of at least some of these entities, none of the financial reports were consolidated with those of the charity, an inadequate related party disclosure was made by one charity, and there were no qualifications in the audit reports. There is clearly a need to identify other controlled entities but this need appears to have been overlooked

Three partners of "big six" audit firms stated that audits of charities are commonly carried out on an honorary or semi-honorary basis. Two of these three stated that there are differences in the way such audits are conducted. These differences relate partly to the level of experience of staff assigned and partly to a

[13]He had considered the debate with his client charity over failure to capitalize fixed assets to be "driven by the amount of funds raised and the amount available."

tendency to distribute honorary audits around the firm. These findings appear similar to earlier findings overseas referred to in section 9.1, and in section 4.5. They were also hinted at in Dixon & Rees (1984) (section 5.5).

Two of the three auditors considered the financial reports of charities likely to have an effect on the fundraising ability of a charity, particularly if those financial reports present the charity as appearing to be wealthy.

In the eight cases where presentation of fund accounting involved a lack of, or misleading, disclosure only one auditor qualified the audit report and the authority cited for the qualification was the commercial environment. There are no fund accounting standards and neither is there any authoritative support for fund accounting issued by the New Zealand Society of Accountants. It appears that those auditing the financial statements of charities practising fund accounting do not look outside New Zealand for authoritative support and the three auditors interviewed all acknowledged some difficulties with fund accounting. This is contrary to auditing standards and perhaps may be an example of the avoidance of problems referred to by those researchers overseas. There are numerous texts published on fund accounting as it is widely practised in the United States, Canada and the United Kingdom. Lack of apparent attempt to determine an appropriate method for presentation of fund accounting may indicate the avoidance of some problems as observed overseas.

Overseas audit guides for nonprofit organizations have been developed for the use of the accounting profession. It appears that such a guide would be helpful in New Zealand.

In carrying out a community service by auditing the financial reports of charities on an honorary or semi-honorary basis it appears that some auditors may be applying a differential audit standard. Although views have been expressed that such audits should not be "less comprehensive" than those paying full fees, the indications are that some such audits do not meet the New Zealand Society of Accountants' mandatory audit standards. Auditors may be encountering some demand for discounted or honorary services from worthy charities while at the same time being required to meet conflicting obligations to their firms. It would appear that in some cases the quality of the audit suffers.

CHAPTER 10

PERSPECTIVES OF CHARITIES

10.1 INTRODUCTION

Overseas increased attention has been paid to charities and nonprofit organizations since the 1975 report of the Commission on Private Philanthropy and Public Needs. Governments adopting 'new public management' policies have effectively increased the role of and demands on the nonprofit sector while at the same time reducing funding to the sector.

Those undertaking the provision of services in a formal contracting environment have encountered increased demands for accountability and most have increased efforts to raise funds to meet those increased demands. These efforts have involved increasing appeals to business and philanthropic organizations for support and increasing profit making activities to allow the subsidization of services provided.

Reasons given for involving the nonprofit sector in the provision of welfare services have included perceptions that nonprofit organizations are less likely to reduce the quality of services provided, are more flexible and are cheaper.

International research has found that financial reports of charities and nonprofit organizations frequently have not complied with accounting standards and that some of those financial reports were manipulated in order to plead poverty.

Representatives of thirty charities were interviewed. The objective was to develop some understanding of financial reporting from their perspective and to discover:

- the extent of distribution of the annual financial reports;
- figures perceived to be important in financial reports;
- the perceived significance of a reported surplus or deficit; and
- whether the financial position of the charity was perceived to have any effect on fundraising.

There were two major types of charities:

- those raising funds for remittance elsewhere to enable charitable work to be undertaken. Such organizations may require little long term investment in assets; and
- those raising funds in order to provide local charitable services. These organizations are more likely to be involved in long term investment in equipment and/or facilities.

This chapter also considers views on the extent to which the financial circumstances of a charity affect fundraising, and discusses other important matters raised either during interviews, or as a result of those interviews.

10.2 DISTRIBUTION OF ANNUAL FINANCIAL REPORTS

The distribution of financial reports varied although in most cases these reports are available on request to members of the general public. Some charities issue a condensed version of their financial report although generally a full version would be available on request. Table 10.1 outlines the extent to which the financial reports are distributed.

TABLE 10.1
Distribution of Annual Financial Reports

	Yes	Available	No	Not Applicable	Total
Parent organization	9	-	1	20	30
Board Members	30				30
All Members	9	12		9	30
Staff	16	7	7		30
Volunteers	2	20		8	30
Funding Organizations	26	1		3	30
Patron	16		6	8	30
Bank	16		14		30
Local Member of Parliament	10		20		30
Members of Parliament generally, or to specific members	10		20		30
News Media	8		22		30
General Public		28	2		30

Others mentioned as being included in the circulation list for annual financial reports included major suppliers, major donors, government departments, lawyers, the National Library, universities, research institutes, doctors and all those attending annual general meetings.

Some charities were clearly using their financial reports as fundraising and public relations documents while others either did not appear to have thought of distributing them widely, or viewed them merely as a necessity with no other uses. Some, especially the larger charities and those using the financial reports as a public relations resource, were providing a considerable amount of supplementary information explaining the purposes and activities of the organization; others, where such supplementary information was provided, tended to include committee reports which commonly assumed a level of knowledge of the charity concerned.

10.3 IMPORTANT FIGURES IN FINANCIAL REPORTS

Those interviewed were asked whether there were any particular figures in the financial statements considered to be more important than others, and the reasons for this. Table 10.2 sets out the important figures and the reasons.

TABLE 10.2
Important Figures in Financial Reports

	Number
Income and Expenditure Statement	
Net operating result	9
Income	8
Cost of services provided (seeing increased costs, increased demand; focus of work from public viewpoint)	3
Amounts from trusts (for distribution to branches)	1
Trading gross and net profit	1
Administration costs (ensure not greater than trading income)	1
Fundraising costs (be aware of costs)	1
Balance Sheet	
Investments (Interest provides income)	1
Movement in accumulated funds (reflects result for year)	1
Accumulated reserves (Indication of solvency)	1
What's in the pot	1
Amounts in particular reserves (Balance sheet is not otherwise significant)	1
Financial reporting is secondary. Acknowledge need funds to support task but don't see performance in financial terms	1
TOTAL	30

The most common answers in respect of the important figures were the net operating result and the amount of income. Reasons for considering the net operating result important included:

- it is the amount available to send[1];
- it affects fundraising next year[2]; and

[1]This organization accounted for fixed asset purchases as expenses so the net operating result was seen as the amount of cash remaining.

- financial viability.

Those viewing the amount of income as important in some cases focussed on sources such as fundraising, legacies and donations. Reasons for importance included:

- need to compare income with budget;
- need to compensate for fall in interest rates with fundraising; and
- income determines expenditure.

Five of the thirty identified balance sheet items as important, with one of those considering the balance sheet to be not significant other than in respect of the figures mentioned. One of the reasons for this was that the organization had been established for many years. Land and buildings owned by the charity are reported at historical cost[3].

The response referring to the secondary role of financial reporting is discussed further in section 10.7.1.

10.4 REPORTED SURPLUS

All those interviewed were asked the significance of a reported surplus. The responses are shown in table 10.3.

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[2]Some organizations noted a link between the reported operating result and the success of subsequent fundraising activities.

[3]Government valuations are included in notes to the financial reports. If land and buildings were revalued in the financial reports, the organization concerned would move from the $25 - $50 million category for total assets in Table 6.7 to the $50 - $100 million category.

TABLE 10.3
Significance of a Reported Surplus

	Number
Enables more grants to be made, resources to be provided, equipment to be purchased	8
Likely to be misunderstood - may make fundraising difficult	5
Offsets deficits, very rare	3
Critical to survival	3
Indicates whether achieving budget	3
Indication of high level of fundraising or bequests	2
May signify objectives not achieved by not spending money on purposes	1
Reflects whether adding or using resources	1
Would expect attention of IRD	1
Should spend, provided have enough funds on hand to run office for 1 year	1
Not applicable	1
Of very little significance	1
TOTAL	30

Some charities operate to raise funds and remit them elsewhere for particular work to be carried out. This appears to require little long term investment in facilities. These organizations generally appear to view a reported surplus as enabling the increased provision of resources.

Others raise funds to carry out charitable work themselves. Some of those carrying out charitable work themselves appear to be aiming for a degree of financial stability and security with one observing the need for continuity and the difficulty of giving help or hope if the organization is shaky. These charities, especially larger ones, view a level of investment in facilities as necessary and a surplus allows the purchase of equipment or resources. Some of the larger charities observed a paradox in perceiving an annual surplus to be essential if the charity is to increase its activities, but that those administering trusts and in government departments "have a huge problem dealing with a figure that is a surplus." It was stated that a reported surplus can result in fundraising being depressed the following year.

However, some of the smaller organizations carrying out charitable work themselves stated a surplus to be very rare and that they were struggling for survival. One of these stated that it was extremely difficult to provide any continuity of basic services because of staffing difficulties. The lower wages and insecurity of tenure resulted in good staff moving to better employment.

10.5 REPORTED DEFICIT

All those interviewed were asked the significance of a reported deficit. The responses are shown in table 10.4.

TABLE 10.4
Significance of a Reported Deficit

	Number
Significant or continuing deficits would lead to closure or cause problems	14
Would result in reduction of funding to programmes	4
Good PR, makes fundraising easier	3
Result in review of fundraising	3
Demonstrates inadequacy of funding	2
Relates to depreciation on donated assets	1
Would mean volunteer numbers are up	1
Not properly budgeted	1
Of little significance	1
TOTAL	30

The perception of a deficit also tended to differ according to the type of a charity. Those raising funds to remit to others tended to view a deficit as leading to a review of the funding provided, although alarm may be caused. Other such charities noted a need to look for additional sources of revenue, viewing a reported deficit as a spur to improvement in fundraising.

Some of those carrying out continuing operations acknowledged that a deficit makes fundraising easier and can enable justification of any fee increases to be made. These charities observed a public perception of success appearing to be a breakeven. One observation made was that although a deficit is "wonderful in PR terms it could be argued that a deficit result is irresponsible."

The two references to inadequate funding related to an organization substantially government funded and a health related organization observing major increases in demand for services. This was said to be a result of policies in respect of hospitalization.

10.6 FUNDRAISING

All of those interviewed were asked whether they knew of financial circumstances of a charity where it may be difficult to raise funds, whether they had encountered difficulties fundraising in the past, and whether they expected difficulties in the future. The responses are shown in tables 10.5, 10.6 and 10.7.

TABLE 10.5
Financial Circumstances Where it May be Difficult for a Charity to Raise Funds

	Number
Costs of fundraising can be prohibitive, need liquidity to pay in advance	8
Awareness of some difficulties but a great deal is dependent on public perception and credibility	4
Level of investments held.	4
If unable to project sustainability, running deficits	3
If the reported surplus is considered excessive	1
No	4
TOTAL	24

TABLE 10.6
Difficulties Fundraising

	Yes	No	Total
Has your organization encountered difficulties due to your financial circumstances raising funds in the past?	14	16	30

Of those stating they had encountered difficulties in the past, eight stated that it was because they were perceived as being too wealthy and two because they were perceived as being funded by government.

One of those interviewed put the view that funding organizations cannot read financial reports, having been refused funds on the basis of being too wealthy at a time when the organization was facing financial difficulties. Similar views were expressed several times in respect of major government funding organizations, banks and trusts. Another comment was that funding organizations prefer to support charities without money.

Those charities without money, however, stated problems trying to fundraise, because the costs involved in mounting a major campaign are prohibitive. One also acknowledged missing fundraising opportunities at a time when it was trying to manage deficits.

The representatives of four charities stated difficulties fundraising because the activities of the charities they represented were not high profile ones. All four charities operated in the health field and expressed concern at lack of interest in their work. In one case it was stated that the particular illness supported was important but there was a perception that those suffering from it were weaklings. "The major trusts are controlled by the 'suit brigade'; men make decisions and it is difficult to obtain funding from them." It was considered that those making the decisions were more likely to provide support in health areas such as heart disease and cancer where they themselves may suffer. Comments were also made that some causes are able to raise funds relatively easily while others encounter difficulties.

Of those not encountering difficulties in the past, one stated that it was largely government funded so that financial position was not currently a major factor, one referred to a stable donor base, one to a partnership with a fundraising organization and one observed that difficulties would be encountered if it did not possess the funds to mount a major appeal.

Public perception of the activities of a charity was also considered very important, with acknowledgement of the need to demonstrate good stewardship. Fundraising problems were perceived as likely to result in the event of large administration costs being reported or of any indication of fraud.

TABLE 10.7
Fundraising Difficulties Expected in Future

	Yes	No	Total
Does your organization envisage difficulties fundraising in future due to your financial situation?	18	12	30

Of those expecting difficulties in the future, seventeen cited falling income as a result of increasing competition among charities, increasing costs of fundraising, and increasing numbers of applications being made to philanthropic and business organizations. These difficulties were in some cases seen to be exacerbated by falling interest income which further increased the need for fundraising. Four of those interviewed stated that they were diversifying to other income earning activities to establish an income base they could control in order to be less reliant on the charitable dollar.

Increasing requirements for services provided were also noted while one charity expressed concern about income being forced down through the process of tendering for services. Further concern was expressed over the ability of staff of recently established funding agencies to read financial reports, such agencies becoming responsible for providing government sourced funding for a number of charities.

Four of those stating that no difficulties were expected considered funding to be a function of public perception of the organization's activities and not its financial position. It is to be noted, however, that three of those four have separate investing and/or trading entities which were not disclosed in their financial reports. Another, not included in these four, had stated that although fundraising difficulties were expected a trust had been created to hold its wealth and this was expected to assist fundraising activities. Creation of such entities is discussed further in sections 10.7.2 and 7.4.1.

10.7 OTHER CONSIDERATIONS

Three other considerations arose during or as a result of interviews with charities and these are important in the context of understanding the views of some charities.

10.7.1 The Role of Financial Reporting

An indication of the role of financial reporting in some charities is given in the last comment of table 10.5. Financial reporting is secondary to the mission of that organization. This comment was received in response to the question about important figures in financial reports, however, a representative of another organization surveyed had also volunteered a similar comment as an aside. The view was that although funds are needed to perform the mission of the organization, society's needs are growing and performance is not viewed in financial terms. "Finances get in the way. Accountants are seen as too rigid, they don't catch the vision".

Given that all charities surveyed received audit certificates that a 'true and fair' view was depicted in their financial reports it would be reasonable for them to believe that despite this secondary role they are meeting their obligations for accountability (see chapter 9 for comments on audit reports).

The secondary role of financial reporting can be difficult to appreciate from the financial reports, especially in those instances where reports are issued unaccompanied by supplementary information, or accompanied only by committee reports that assume a high level of knowledge about the organization's activities. If additional information about a charity and its purpose is not supplied judgements about it can be made only on the basis of financial information.

10.7.2 Investing and/or Trading Entities

The comment made in section 10.6 that a trust had been created to hold the wealth of a charity and that this was expected to ease fundraising problems may leave the impression that the creation of all such entities is to enable wealth to be hidden. Clearly there may be an element of that, however, there are also other likely reasons for these entities to exist.

As noted in section 7.4.1, there may be external restrictions on some, or all of the funds held by an investing entity. In the case where one was established following a special fundraising appeal, the amount raised may be subject to restrictions. Such funds, whether held by the investing entity or the charity concerned, may be unavailable for spending. Presentation in the financial reports of the charity concerned could lead to the mistaken opinion that the charity had the freedom to dispose of them. The existence of external restrictions on the funds of these entities was not questioned, however, in some cases, some of the amounts held may be externally restricted.

An officer of a self-regulatory organization for fund raisers was asked for reasons that charities may establish such separate entities. These were stated to relate to obtaining the involvement of "people with connections". Such people were perceived as more likely to be able to raise money, expecially where the board members of the charity were lacking such connections. This person also considered that charities possessing money were becoming more acceptable than in the past although too much money may be a disincentive to potential contributors. Financial statements were not seen as significant when mounting public appeals, but particular types of causes were likely to find fundraising relatively easy while others would have difficulty.

10.7.3 Self-Regulation

In addition to the self-regulatory organization for fund raisers mentioned above, one interview led to the realization that such a self-regulatory group also exists for some charities in New Zealand. This is the New Zealand Evangelical Missionary Alliance which is affiliated to the Evangelical Council for Financial Accountability, a self-regulatory group in the United States (section 3.5.2).

10.8 SUMMARY

Although some of the financial reports are widely distributed while others are not, most are available to the general public and are used when applying for funding. Important figures identified in financial reports predominantly were the reported net operating result and income. The reasons for the importance of these items related to the ability to carry out the work of the charity.

The significance of a reported surplus also most commonly related to increasing the ability to do the work of the charity, however, some charities observed that a reported surplus would also affect fundraising in the following year, making it more difficult to raise funds. Significant or continuing deficits were considered to threaten the existence of a charity, although again, a deficit result was considered likely to make fundraising more successful in the following year.

The financial circumstances that would make it difficult for a charity to raise funds were most commonly stated to relate to the costs of fundraising. The costs of major appeals were acknowledged as being prohibitive by those who had encountered difficulties, and by those who could conduct such appeals but realized others could not. However, of those that had encountered difficulties fundraising, a number stated that it was because they were perceived as too wealthy.

Expected difficulties in future fundraising related to increasing competition among charities for available funds and increasing costs of fundraising. Such expected difficulties had led to some charities diversifying to undertake some profit seeking activities in order to reduce the level of reliance on donors. Others expected increasing difficulties as a result of increasing demand for the services provided, income being forced down through the contracting process. Some of those not expecting difficulties, although they appeared to consider funding to be related to public perception of the services provided, had also arranged their financial affairs in a manner that gave the appearance of the charity not possessing wealth.

Some of the effects of 'new public management' observed overseas are also evident in New Zealand. These include:

- increasing demands on charities for their services;
- increasing competition among charities for funds available;
- some moves to develop profit-making activities to subsidize the charitable work provided.

Charities may provide welfare services to the extent that they are able to raise the funds to do so, however, philanthropic particularism, noted overseas as one of the areas where voluntary failure occurs means that charities in particular service areas may be able to raise funds easily and provide the services required, while others will have difficultly raising funds and consequently be unable to provide services to meet demands. There were indicators that such a problem is likely to occur in New Zealand.

A number of charity representatives interviewed indicated a need to appear poor in order to receive contributions from funding agencies. Such a situation would certainly provide an incentive to plead poor, as observed overseas.

Some of the comments made referred to funding agencies, including those providing government sourced funds, lacking the ability to interpret financial reports (see chapter 11 for perspectives of funding organizations).

CHAPTER 11

PERSPECTIVES OF FUNDERS

11.1 INTRODUCTION

Research overseas has shown that charities may manipulate their financial statements to plead poverty and that, although not complying with accounting standards, clean audit reports may be issued.

Reductions in government funding of charities together with increasing demands for their services has resulted in increasing appeals for support to corporations and funding bodies.

In chapter 9 it was noted that two of the three auditors interviewed considered that a charity appearing wealthy would encounter difficulties fundraising with one expressing the view that some funders of charities, particularly those in government departments lacked the knowledge to evaluate financial reports.

In chapter 10 representatives of charities noted that funding agencies were being subjected to increasing numbers of applications for funds. Eight expected to encounter difficulties fundraising in future through being perceived as wealthy and two through being perceived as funded by government. A representative of a self-regulatory organization for fundraisers also considered too much money to be a barrier to fundraising although the possession of some money was becoming more acceptable.

Representatives of seven funding organizations were interviewed seeking an understanding of the role of financial reports in assessing funding applications. Six of these organizations were philanthropic trusts and one a major source of funds from the government.

This chapter outlines the financial reporting these funding organizations require from charities applying for funds. The perceived relevance of including in the charity financial reports those of other entities such as divisions and investing or trading entities is considered.

An indication was sought whether specific methods are used to analyze financial financial reports submitted by charities seeking funds. Additional information sought was the level of reliance on financial reports and other factors taken into consideration when assessing a funding application. Views in respect of figures perceived as important in financial reports and the perceived significance of a reported surplus or deficit are outlined.

The reasons funding applications may be rejected outright as a result of information in financial reports are also considered.

11.2 REQUIREMENT FOR AND RELIANCE ON FINANCIAL REPORTS

The requirements for financial reports from funding applicants are set out in tables 11.1, 11.2, 11.3 and 11.4.

TABLE 11.1
Requirement for Financial Reports

	Yes	No	Total
Do you require applicant organizations to provide recent financial reports when submitting a grant application?	7	0	7

TABLE 11.2
Inclusion of Division Financial Reports

	Yes	No	Total
Some organizations have many divisions. When you receive an application from a national organization do you expect the financial reports to include those divisions	0	7	7

Two of those interviewed stated a rule that national organizations only may apply for funds. If divisions are seeking funding then the national organization must apply on behalf of the divisions and financial reports would be required of each division seeking funding. One considered consolidated financial reports would cause problems, although an analysis by area would help to reduce those problems. Another thought a requirement for consolidated financial reports to be worth thinking about.

TABLE 11.3
Inclusion of Investing Entities

	Yes	No	Total
Some organizations have established separate foundations (investing entities). When you receive an application from a national organization do you expect the financial reports to include information about such an entity?	5	2	7

One of those answering "no" stated an awareness of such entities being formed, but those financial reports had never been requested. One answering "yes" considered that if an organization is "well set up" then there is no need for funds. Two stated as an aside that they would not give sums to be invested.

TABLE 11.4
Audited Financial Reports

	Yes	No	Total
Does it assist your decision if the financial statements are audited by a chartered accountant?	4	3	7

All of those stating it does not assist their decision if the financial reports are audited by a chartered accountant also stated that audited financial reports are required.

11.3 ASSESSMENT OF FINANCIAL REPORTS

Those interviewed were asked about their method of assessing financial reports, the level of reliance, important figures and the significance of a surplus and of a deficit. Their responses are in tables 11.5 to 11.8.

TABLE 11.5
Method of Assessment of Financial Reports

	Yes	No	Total
Do you use any checklist to work through when reviewing the applicant's financial reports?	0	7	7

The representative of one organization with large amounts of funds stated that it would be preferable to use a checklist but one had not been developed. Another of those interviewed reported the presence of three accountants on the decision making board and a perception of no need to establish such a checklist. Most, however, expressed an interest in developing a checklist.

TABLE 11.6
Level of Reliance on Financial Reports

How much weight is placed on the financial reports when making a decision	Number
A lot - to establish need for funds	5
10% person making decision not a finance person	1
Not a lot unless something is wrong	1
TOTAL	7

Different views expressed in respect of establishing the need for funds included:

- charities were sometimes reluctant to spend their own money and that those with less money were more likely to receive grant funds;
- there would be more weight placed on financial reports in assessing large applications than small ones;
- if a large amount of cash were held or a large surplus were reported the application would be declined with the reason stated allowing the charity concerned to provide an explanation if it wished to pursue the application;
- larger known charities were more likely to obtain support without financial reports.

Information was sought on relevant factors other than financial reports and this included:

- the criteria of the funding organization for allocating funding;
- the worth of the project;
- the number of people to be helped by the grant.
- whether the services provided by the charity are a duplication of other available services;
- the credibility and track record of the charity;
- establishment of an association with applicant charities, assessing the quality of those involved;
- the objects of the charity.

TABLE 11.7
Important Figures in Financial Reports

	Number
Balance Sheet	
Current assets, current liabilities	1
Investments (to establish whether charity can reasonably be expected to fund the project)	1
Investments held, level of cash build up, liabilities	1
Cash balance, investments, net worth	1
Cash and investments, current liabilities, accumulated funds (to indicate amount of money held and whether grant is necessary)	1
Assets (reasons sought for holding real estate), liabilities (how are they organized)	1
Income and Expenditure Statement	
Trend of income and expenditure, funding from other charitable organizations (to establish whether efforts are being made to increase income - but may get lower grant if getting funds elsewhere)	1
Ability to balance income and outgoings (if accumulating surpluses then don't need help)	1
Fundraising, grant assistance (check whether need help)	1
Amounts granted by others (helps the application) amounts from government funding (not prepared to fund organizations seen as government responsibility) surplus (not necessarily detrimental, OK if covers 2 years operational administration).	1
Amount of government funding, surplus or deficit (large surplus is likely to result in application being declined).	1
Sources of donations, costs of administration.	1

Comments made about important figures identified included:

- organizations perceived as the responsibility of the government would not be funded. These included schools and charities perceived as largely government funded; and
- recognition of a need for voluntary organizations to become self-sufficient and acceptance that a level of investments would be acceptable depending on the project being applied for.

TABLE 11.8
Significance of Any Reported Surplus or Deficit

	Number
Surplus	
Indication of effectiveness, whether making own efforts, may result in reduction of grant	1
If accumulating surpluses then no help is required	1
Sometimes important, want to find out why	1
Indicates good management but size of surplus is important. If major surplus a small grant application would not be considered	1
Consider in relation to turnover	1
Dislike view of building up nest egg	1
Indicates how good management is, not looking for large surplus	1
Deficit	
No wish to fund deficit. In making funding decision want to ensure organization can continue	2
If to point where unable to function, significant deficit would prevent funding; relate to size of organization, grant purpose	1
Won't give to mismanaged charity, where obviously not going to survive - won't give	1
If material would want to know why	1
Sometimes important, want to find out why	1
Not considered good if expenses are high in relation to income. Want to know if deficits how project will be managed in future	1

In stating their views of the significance of a reported surplus three of those interviewed saw a small surplus as an indication of good management. One stated that the surplus would be examined in relation to turnover. It was also clear that a reported surplus may have an effect on a funding decision.

In some cases a reported deficit would also be a bar to funding, particularly if there were concerns about mismanagement or doubts whether the organization would survive. However, this view was balanced, in particular by one person who stated that more than one year would be considered as well as future plans.

11.4 REJECTION OF FUNDING APPLICATIONS

Although all funding organizations clearly require financial statements and use them for making a decision, other factors are also considered. Those interviewed were asked whether there was anything in the financial reports alone that would result in rejection of an application. Their responses are in tables 11.9 and 11.10.

TABLE 11.9
Rejection of Funding Application

	Yes	No	Total
Is there anything in the financial reports alone that would cause you to reject or have doubts about an application for funds?	6	1	7

TABLE 11.10
Rejection of Application for Funding from Financial Reports Alone

	Number
Evidence of insufficient efforts to increase income	1
A start up project - may not get off the ground. Any grant would be made conditional on raising other funds	1
If a government responsibility, such as schools. (Outside criteria)	1
Either substantial surpluses, substantial deficits, level of investments, significant government grants	1
Major premises - dislike of empire building	1
Doubts caused by large overseas travel, perks, commission on fundraising	1

Two of those interviewed stated that they would not be interested in funding capital sums such as those for investment. They review financial reports primarily to see for themselves whether the charity is able to fund the proposed project, or if it is possible the charity will not survive. A badly managed charity is seen as one incurring regular deficits and is unlikely to be funded, while in some cases a surplus, particularly a large one is likely to result in a reduction in the amount requested or the funding application being declined.

Although most funding agencies examined the financial statements to decide whether the applicant organization could fund the project itself, two indicated they would dismiss an application under these circumstances, and one of those appeared likely to invoke a dismissal of an application only when there was evidence of 'empire building', particularly if premises were owned.

11.5 SUMMARY

The representatives of these seven funding organizations were all involved in the responsibility of assessing applications for funding. Each of the funding organizations has its own objects and funds given to charities must be given in accordance with those objects.

All required audited financial reports to support any funding application and four considered it to help their decision making if the auditor is a chartered accountant. All expected financial reports to exclude branches but, where applications were made on behalf of branches, the financial reports required were of each entity seeking funds. Five of those interviewed expected the financial reports of a charity to include any investing entity.

None of the seven representatives used any form of checklist in assessing the financial reports of funding applicants. Five placed a great deal of weight on the financial reports, relying on them to decide whether the funding applicant needed the money applied for. Although all seven tended to consider different combinations of figures important, they related largely to determining whether the money was needed, although in the absence of specific checklists it was not clear what that 'need' is.

Views expressed in respect of a reported surplus or deficit showed that such figures have a bearing on funding decisions. In some cases reported surpluses clearly were a barrier to charities being funded. Excessive amounts of cash or investments were also a barrier to a decision to provide funds. One of those interviewed volunteered that an acceptable surplus would be one that covered two years' administrative expenses but there were no indications given of the levels of investment and cash held that would be considered acceptable.

In a few cases, there did appear to be a focus on 'bald figures' (chapter 9), this being particularly the case with the representative of the organization providing a major source of funds from the government. When asked for important figures in financial reports it was noticeable that no one referred to the information contained in a statement of cash flows. These findings tend to confirm some of the views of charities and auditors that a surplus or 'excessive' wealth may result in a refusal of a funding application.

In two cases part of the assessment of financial reports included deciding whether the applicant organizations are a government responsibility while other considerations included sources of other funds granted and an examination of administrative costs.

All seven representatives considered other factors when assessing a funding application including the worth of the project and the credibility of the funding applicant. When asked for reasons why an applicant may be refused funding on the basis of financial reports alone only one referred to the level of investments and substantial surpluses; other matters were generally referred to.

It was evident, however, that most of these organizations see themselves as funding charities undertaking worthy projects and perhaps achieving small surpluses, but without large investments.

CHAPTER 12

SUMMARY AND CONCLUSIONS

12.1 INTRODUCTION

My thesis is that there are special issues affecting charities in New Zealand and that those special issues need to be borne in mind when setting accounting standards that apply to charities. This research bears out that thesis. Some of these issues relate to the role of the nonprofit sector, which is expanding, and the general lack of supervision of that sector in New Zealand. Others relate to the differences between charitable and business organizations, and the need to be aware of those differences in developing a conceptual framework and in setting accounting standards.

This chapter summarizes and draws conclusions for charities in New Zealand about:

- the role of the nonprofit sector, the adoption by governments internationally of 'new public management' philosophies, and the consequent effects on the nonprofit sector;
- mechanisms for supervision of the nonprofit sector;
- the calls for improved accountability of the nonprofit sector and fund accounting, because fund accounting terminology and concepts are adopted in the conceptual framework;
- the FASB's conceptual framework project, its extension to the nonprofit sector and other conceptual framework developments affecting New Zealand; and
- the accounting standards being developed for the nonprofit sector.

The conclusions drawn are a result of considering all of these factors both together and in isolation. They lead to the view that there are matters that all parties involved in the charitable sector should consider.

Limitations to the research is outlined and directions for future research proposed.

12.2 THE ROLE OF THE NONPROFIT SECTOR

'New public management' in New Zealand, as overseas, is leading to increased responsibilities for and demands on the nonprofit sector as well as reductions in direct funding to the sector. The increased responsibilities result from the contracting out of welfare provision previously undertaken by public sector bodies. In this aspect of welfare provision nonprofit organizations may be competing with governmental or for-profit organizations for that role.

The nonprofit sector is being subjected to increased demands to 'pick up the pieces' resulting from reductions in government provided services and welfare benefits. An example of the cuts affecting the nonprofit sector relates to policies such as reduced hospitalization of the mentally ill accompanied by increased reliance on 'the community' to support those people. In this aspect of welfare provision nonprofit organizations are not competing with government or business organizations but are attempting to provide services that will not otherwise be provided. They require money to do this. As observed overseas they are obtaining this in two ways:

- increasing their approaches to philanthropic and business organizations for financial assistance; and/or
- trying to develop a degree of self sufficiency by undertaking investing or trading activities. Such activities reduce reliance on charitable funds and provide some security.

12.2.1 Approaches to Philanthropic and Business Organizations

Funding organizations are being subjected to increasing numbers of applications for funding and must somehow decide on who to provide money to and who to decline. This reliance on philanthropic agencies causes a danger that there will be no balance of priorities for the public good. Such a danger was highlighted in the 1989 report of the Audit Office on the New Zealand Lottery Board. This report noted the absence of any detailed criteria for deciding on successful funding applications:

> The system of identifying need is based on advertising the availability of funds and the committees' criteria. The committees rely on the premise that, if the availability of funds is widely known, then applications will reflect the greatest need. ... The Board does not have data to measure the effectiveness of its advertising. There is no assurance, therefore, that distribution committees address public expectations. The committees do not target funding to address perceived areas of need. (p14)

As noted in chapter 2 those charities most able to provide services will be those best at fundraising, and not necessarily those where the greatest demand for services exists. All of those philanthropic organizations interviewed have basic criteria within which they allocate the money available. Most use the information in financial reports when deciding whether the money applied for is needed but none use any detailed criteria for guidance in analyzing those financial reports. Funding agencies now carry an increased responsibility and it seems inevitable that some important needs will go unmet.

12.2.2 Developing Self Sufficiency

Some charities are undertaking their own profit making activities to help support the services they provide to the community. They may also, perhaps, perceive the possibility of achieving some surplus on contracted welfare provision to subsidize other services. It seems inevitable that here, as overseas, claims of unfair competition with business organizations will arise.

Those charities not undertaking such activities, but attempting instead to retain some resources to earn investment income from them may be subjected to criticism for not spending those resources on their charitable purpose. Interviews with representatives of funding organizations brought out quite clearly that the existence of 'too much' invested may result in a refusal although it was not clear what 'too much' is.

Representatives of charities view this as an incongruous situation. On the one hand, to be able to plan to provide an adequate level of continuing service, considerable investment in resources may be required and there must be a level of assurance of a minimum income. On the other hand, the disclosure of attempts to secure such an investment income is perceived to lead to penalization of other fund raising attempts. This may have provided some incentive for charities to establish separate undisclosed investing or trading entities.

12.3 SUPERVISION OF THE NONPROFIT SECTOR

Overseas both fundraising practices and charities themselves are subjected to some official supervision. In return for that supervision they receive and retain tax free status, and those fundraising are permitted to approach the general public for funds.

As was stated in 1979, in New Zealand "charitable trusts are uniquely free from supervision" (Property Law and Equity Reform Committee, 1979, para 4). Given the auditor general's comments about the supervision of incorporated societies (see section 5.6.2), it is clear that the supervision of charities generally is minimal. Although there have been two publicly funded inquiries into charities and welfare organizations (the Property Law and Equity Reform Committee, 1979 and the Working Party on Charities and Sporting Bodies, 1989), no action has been taken and charities continue to be free of any effective ongoing reporting and/or auditing requirements. It is to their credit that all those taking part in this survey consider themselves publicly accountable and all except one, a very small one, voluntarily subject themselves to audit.

The ease with which a charitable trust may be established and tax free status obtained enables the establishment of new charities to fill needs not already being met. However, the lack of supervision following such establishment of a charity leads to enormous ability for private gains to be made and danger of a general loss of credibility for the sector as a whole. Easy possibilities for private gain are exorbitant charges for 'management fees' or 'selling' other services or goods to a charity at an inflated price, thus diverting money raised. There are also no controls over fundraising practices and uses of money raised.

As well as a lack of regulatory supervision, there is little activity in self-regulatory practices. There appears to be one organization adopting self-regulatory practices for fundraising and one that has developed accountability standards for evangelical organizations.

This lack of supervision is one of the special issues of charities in New Zealand. Concerns were raised by some of those approached during this research that 'rip-offs' bring the whole charitable sector into disrepute. It leaves the charitable sector open to abuse and endangers the reputation and fundraising ability of the sector generally. It also results in lack of specification of minimum reporting practices. Overseas such requirements have some effect on accounting standards being developed.

Given the increased reliance on this sector to provide the 'community support' necessary to make 'new public management' tolerable the lack of attention to supervision is surprising. A reduced ability to raise money will inhibit the ability of this sector to contribute to the provision of community support. Certainly the most recent publicly funded working party, when outlining the role it proposed for a Charity Commission, made the position clear:

> The New Zealand charitable sector is on the brink of major growth and development. ... the community will be required increasingly to meet health, education and welfare needs which at one time were met through tax revenues. As the charitable sector expands there will be an increasing need for charities to be accountable. (Working Party on Charities and Sporting Bodies, 1989. p90)

12.4 CALLS FOR IMPROVED ACCOUNTABILITY

The first major calls for improved accountability arose from the report of the Commission on Private Philanthropy and Public Needs which sought a single set of accounting principles for the nonprofit sector. At the time, in 1975, fund accounting was very much the norm in the American nonprofit sector. The accounting profession's neglect of the sector meant that there had been little or no standardization of financial reporting practices and fund accounting was criticized. Even Weinstein (1978) who opposed fund accounting acknowledged that the way it was being used would not have been intended. Weinstein also noted biases in the AICPA group developing the statement of practice (SOP 78-10) with those working in the nonprofit sector apparently supporting fund accounting, while those not working with the sector opposed it. One of Weinstein's reasons for opposing it was that non profit organizations should not expect business people to learn to understand fund accounting (p 1016).

Variations of fund accounting or reserve accounting are practised in New Zealand but no authoritative standards have been developed here. Although in some cases the fund accounting practices resulted in nondisclosure or misrepresentation (see chapter 7) only one auditor qualified the financial reports for this and the authoritative source was stated to be the commercial environment.

The three auditors interviewed appeared to have little understanding of fund accounting and to have made little attempt to determine authoritative standards (see chapter 9). The number of disclosure problems arising from fund accounting practices together with lack of auditor attention to this matter lead to the view that both reporting and auditing failure is occurring. An authoritative reference on fund accounting practices for the information of both auditors and charities would alleviate the problem.

Researchers have criticized financial reports of nonprofit organizations, observing manipulation of financial reports and failure to observe accounting standards. These observations may lead one to the conclusion that the nonprofit sector is evading its responsibilities for accountability.

In New Zealand this research shows a similar pattern with some manipulation of financial reporting and lack of compliance with basic accounting standards. In some cases, the charities were unaware of the breaches in accounting standards, in others there was an awareness. There is a further similar pattern in New Zealand to that observed overseas. The financial reports of the charities are accompanied by clean audit reports even where breaches of standards exist.

The auditors interviewed clearly felt some pressure or obligation to provide audit services to charitable organizations free or for a reduced fee. In doing this there appear to be some practical measures taken to reduce the costs of providing such a service. Auditors expressed concern at the failure of charities to realise that accounting standards apply to them. However, although accounting standards apply to charities they are under no legal obligation to comply with them. Members of the New Zealand Society of Accountants have professional auditing standards which apply to any member conducting an audit. They are expected to comply those standards and there are procedures to follow where financial reports do not meet accounting standards. An informal differential quality of auditing appears to have evolved. In addition to the possible risk to auditors under the Fair Trading Act, such auditing brings the accounting profession into disrepute. Such auditing may also delude charities into thinking their financial reporting practices are acceptable and that they are fulfilling their obligations for accountability.

There is no authoritative guidance for auditors of charities in New Zealand. Charities have special features and auditing guidance would increase awareness of those features.

12.5 FASB'S CONCEPTUAL FRAMEWORK

The FASB has spent large amounts of time and money developing its conceptual framework. The other countries surveyed have relied heavily on the FASB's work. That reliance involves an assumption, or agreement, that the FASB's efforts are appropriate. Given the many criticisms of the conceptual framework and its applicability to the nonprofit sector some caution is called for. Acknowledgements by FASB members that the conceptual framework cannot alone solve the many problems of financial reporting or be applied deductively to develop accounting standards also requires acceptance. Views on the extent of the conceptual framework's usefulness appear to have changed over time.

Attention was paid to the financial reporting of the nonprofit sector in the mid to late 1970s, at the time when the conceptual framework was perceived to be a panacea for accounting's ills. Anthony (1978) concluded that the transactions nonprofit organizations engage in are similar to those of business organizations except for restricted contributions and contributions of capital, and after developing and considering SFAC4 *Objectives of Financial Reporting by Nonbusiness Organizations* the FASB decided to extend its conceptual framework to the nonprofit sector. It modified SFAC2 *Qualitative Characteristics of Accounting Information* and revised SFAC3 *Elements of Financial Statements of Business Enterprises,* reissuing it as SFAC6 *Elements of Financial Statements.*

12.5.1 Economic Focus of the Conceptual Framework

Milburn (1991) considered the conceptual framework incomplete in its failure to address the limits of economic reasoning. The FASB states that the conceptual framework leads to financial statements that report on "economic things and events" (FASB, 1992, SFAC1, para 18; SFAC4, para 23), but nowhere does it define those economic things and events.

In extending the conceptual framework to the nonprofit sector the FASB has encompassed an area where its economic focus may, at times, be stretched beyond its limits. The FASB, however, has not even defined what the economic focus is. When the conceptual framework was intended only for business organizations such an omission may not have been a problem, but in its extension to the nonprofit sector this matter requires rectification. The decision that all contributed services are economic events is a case in point. There has been no explanation of the reasoning involved and its applicability to decision useful financial reporting may be challenged.

Australia and New Zealand are contributing to further development of the conceptual framework. Australia has developed its reporting entity concept and New Zealand is addressing non-financial elements of financial reports and the associated statement of service performance.

Australia's reporting entity concept states that for a group of entities where one exerts control over others in order to meet one's objectives then there exists one (combined) economic entity. However, if the controlling entity's objectives are not economic ones, is that logic necessarily correct? The reporting entity concept fails to address what is meant by an economic entity and consequently, if the reasoning in that concept is used the development of accounting standards requiring consolidated financial reports may be inappropriate for the nonprofit sector.

New Zealand's non-financial elements are intended to disclose matters unable to be dealt with through monetary measurement but it is not clear which matters should be subjected to a financial focus and which should be dealt with as non-financial elements.

Failure to clearly define the focus of the conceptual framework and its boundaries will be to the detriment of the nonprofit sector whenever the boundaries of the economic focus are breached.

12.5.2 Application of Definitions

The FASB's approach to contributed services appears to be a refusal to acknowledge the decision usefulness focus of the conceptual framework when what is decision useful conflicts with what the FASB may prefer.

The FASB only declared all contributed services to be revenue 'in concept' after the results of its survey which found such information not to be useful to users. That declaration enabled a 'conceptual' approach to be taken whether such information was decision useful or not. The FASB used aspects of the qualities of information in SFAC2 to justify its requirement that some contributed services be recognized. It used different aspects of those qualities to justify the different stands it took over contributed services. In doing so it demonstrated clearly the concerns raised over the American Accounting Association (1966) standards for accounting information; without any demonstration that such information is relevant "there is the danger that relevance and irrelevance can be tossed about as 'appropriately match' has been in the past (Sterling, 1967, p109). The FASB's method of dealing with contributed services does not show the FASB in a good light.

A comparison of the FASB's approaches to restrictions on contributions, conditional contributions and pledges shows further inconsistency in application and interpretation of the conceptual framework.

12.5.3 Decision Usefulness of Financial Reports

The FASB acknowledged the focus of users of the financial reports of nonprofit organizations to be different from that of users of financial reports of businesses. That different focus was re-iterated when the revised elements of financial statements were exposed for the second time (Bossio, 1985) and, like SFAC4 and the concept of restrictions, had connotations of fund accounting ideas.

Without acknowledgement of that different focus it may be questioned whether the second exposure draft would have been accepted[1]. The FASB defined all contributions as revenue. Had it been stated that financial reports would be required to focus on changes in net assets instead of inflows and outflows of resources those definitions may have been rejected and, as Kerr (1989) stated, a need would have arisen to differentiate contributions that are capital from contributions that are revenue, or those that relate to operations from those that do not.

Whether intentional or not, the FASB's method of avoiding this task brings credit neither to it nor to its conceptual framework.

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[1]With hindsight, Bossio's comment that similar interests outweigh differences (Bossio, 1985, p4) (see section 3.7) may perhaps be seen as a warning of the changes to come.

The conceptual framework takes a decision usefulness approach, assuming that those who use financial reports will make the effort to understand them. "In a fundamental sense, decision usefulness is the entire conceptual framework; all the rest is commentary" (Alexander, 1982, p2).

SFAC4 mentioned that the levels of understanding of users of the financial reports of nonbusiness organizations may be lower than for others (para 37), however, the approach taken is that the use of financial reports should be learned although "efforts may be needed to increase the understandability of information provided by financial reporting" (FASB, 1992a, SFAC4, para 37).

The assumption that users will make the effort to understand financial reports is taken a step further in Australia's conceptual framework where it is suggested that professional advice may be sought (AARF, SAC3, para 37). Is it reasonable that users of financial statements of nonprofit organizations should need to seek professional advice to understand them?

Vatter (1947) acknowledged the low level of understanding of many users of financial statements and the common misunderstanding that causes income to be confused with cash balances (p76). Educating users, in his opinion, was a massive task. In the forty six years since Vatter's publication it is not clear that any progress in educating users has been made. Charities and auditors both expressed concern about user understanding with some drawing a link between a reported surplus and difficulties in fundraising the following year. Some of those in philanthropic organizations clearly carry the misunderstanding Vatter referred to with a major organization stating that a grant may be reduced in the event of a surplus being reported. These misunderstandings cause difficulties for charitable organizations when setting membership or other fees as well as when fundraising.

Those difficulties will be exacerbated by the definitions adopted for contributions and insistence on a focus on change in net assets. The FASB appears to have compromised the most important focus of its conceptual framework: that it should be decision useful. If lay users of financial reports misinterpret their meaning, how can those reports be decision useful?

12.6 ACCOUNTING STANDARDS

12.6.1 Standard Setting

In New Zealand, as overseas, concerns have been expressed about the lack of broad participation in the standard setting process. It is at the exposure draft stage that the greatest opportunity for participation arises but predominantly those participating represent major corporates and accounting firms.

Given the apparent differential auditing of charities it is logical that charities may consider accounting standards do not apply to them. Efforts are needed to publicize the application of accounting standards and to encourage wider participation of the nonprofit sector in the standard setting process[2]

12.6.2 Presentation of Financial Reports

It is in the presentation of financial reports that the effect of the definitions in the conceptual framework may be seen most clearly with difficulties encountered in the United States, Canada and the United Kingdom.

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[2]The exceptional efforts made by the New Zealand Society of Accountants to involve the nonprofit sector in ED-70 are acknowedged.

Restrictions

The concept of restrictions does not necessarily require multicolumned reporting but such a style of reporting may perhaps be more easily understood by unsophisticated users who would otherwise focus on the change in net assets and not notice the extent to which income is restricted. The concept of restrictions also implies fund accounting to enable adequate records to be kept. This is particularly the case in New Zealand where proposals are for information not only on restricted income, but also on restricted assets and restricted liabilities.

Fund accounting and its concepts appear to be ignored in New Zealand and it is perhaps a little unfortunate that the decisions taken to apply the conceptual framework to nonprofit organizations are so deeply rooted in fund accounting. ED-70 *Accounting for Grants and Donations,* proposed by the New Zealand Society of Accountants, whether knowingly or not, incorporates fund accounting concepts. This may well be an appropriate method of dealing with transactions in order to provide information useful to users but such a move should be made knowingly, and if it is to be made the lack of authoritative guidance in New Zealand and lack of knowledge auditors display about fund accounting urgently requires rectification.

User Focus

It may be that if the FASB had followed through on its earlier acknowledgement of the focus of users of financial reports and proposed a presentation for financial reports in accordance with that focus there would be fewer concerns about the way it has handled its nonprofit project.

The FASB reneged on its statements about information useful for users of financial reports of nonprofit organizations. The reason given for repudiating its earlier statements is that "a single statement of 'funds flows' might unnecessarily confuse items of revenue ... with expenditures to acquire non-current assets" (FASB, 1993, SFAS117, para 46). There is no suggestion that the information earlier stated to be useful is not now useful to users. The focus appears not to be on users and decision usefulness at all.

The difficulties the FASB encountered with the presentation of financial statements is a problem of its own making as it could have defined capital and revenue differently and, as Kerr (1989) observed, will need to if there is to be a focus on an operating measure.

Mautz (1989) and Herzlinger & Sherman (1980) both objected to the possibility of the financial statements of nonprofit organizations being presented in the same format as those of business organizations with Mautz recommending some experimentation with financial statements.

Anthony (1993) predicts that nonprofit organizations will not follow SFAS117 *Financial Statements of Not-for-Profit Organizations*. It remains to be seen whether his predictions are correct, however, in both Canada and the United Kingdom such a presentation is not proposed, the United Kingdom having rejected the SORP2 (ASC, 1988) proposal.

It is to the credit of the CICA in Canada and the CARC in the United Kingdom that they have not blindly followed the FASB in their requirements for presentation of financial reports.

Canada has attempted to please both the supporters of fund accounting and those who prefer the more common business style financial statements. In doing so it has varied the views of its conceptual framework. Such an approach is not desirable as a way of standardizing financial reporting.

The 1993 version of SORP2 (CARC, 1993) proposes a layout very much in accordance with the information the FASB had earlier acknowledged as useful for users of financial reports; "information about the amounts and kinds of inflows and outflows of resources during a period" (FASB, 1992, SFAC4, para 48). It focusses on "the periodic measurement of the changes in the amounts and nature of the net resources of a charity" (Framjee, 1993d) (see Appendix 3)

In New Zealand, ED-67 *FRS9: Information to be Disclosed in Financial Statements* as proposed by the New Zealand Society of Accountants, like the financial statement presentation promulgated by the FASB, concentrates on the change in net assets. This statement is inappropriate for charities. If the concept of restrictions is to be followed then the ability to present multi-columned statements will be necessary. If the definition of revenue is not to be revisited, and revised, the focus of presentation of financial reports will require changing and the SORP2 developments appear to be the most promising. Simply adding extra reports and notes to explain will not remove the likelihood of misinterpreting the financial reports.

> Even though supplementary exhibits are presented, the core of all financial reporting is the income statement. (Vatter, 1947, p68)

> Education of the public is desirable and should be striven for, but it is not a very satisfactory solution to the problem of how financial data should be reported to people who 'do not like' to analyze accounting reports. (Vatter, 1947, p 76-77)

12.7 CONCLUSION

The increased role of the nonprofit sector increases the need for charities to raise money to carry out their objectives but in New Zealand there is no ongoing supervision of charities. The nonprofit sector is open to financial abuse, a loss of credibility and consequent fundraising difficulties. Calls to improve accountability in the nonprofit sector overseas have not been matched in New Zealand. The impending major financial reporting changes are a result of the FASB's conceptual framework, aspects of which have developed from fund accounting roots. The accounting practices of charities in New Zealand match those found overseas in the late 1970s and early 1980s with failure to comply with accounting standards and clean audit reports issued.

Although some charities practise fund accounting there is no authoritative guidance in New Zealand for fund accounting practices and such guidance appears to be needed together with audit guidelines and an increased awareness by charities of both the application of accounting standards and the process of standard setting.

There are flaws in the conceptual framework which are likely to be to the detriment of charities. One of these flaws is the failure to define the economic focus of the conceptual framework and to define what the economic things and events are that financial statements report on. These flaws extend to Australia's reporting entity concept and New Zealand's non-financial elements.

Another flaw is the assumption accompanying the decision usefulness focus that users of financial reports will make an effort to understand financial reports. Given an acknowledged lower level of understanding of users of financial reports of nonprofit organizations, the findings of this research, and Vatter's observations about educating users the conclusion drawn is that financial reports on nonprofit organizations require modification to accommodate a lower level user understanding. Insistence on focussing on changes in net assets will be to the detriment of nonprofit organizations. If the whole conceptual framework is decision usefulness then it will fail by refusals to accommodate user understanding.

12.8 LIMITATIONS OF THIS RESEARCH

There is no collection point for data on the largest charities or the largest fundraisers in New Zealand. Consequently it was not possible to obtain a truly representative sample to survey. Because of this there are limitations to the research in that statistical analysis cannot be applied. Instead, however, a pattern matching approach has been applied to determine whether findings in New Zealand match documented findings overseas. Generally they do.

This research was broad and exploratory to try to determine an overall view of the charitable sector. Because of this there are a number of areas touched on only lightly and much could be gained from further research.

12.9 DIRECTION FOR FUTURE RESEARCH

Bird (1985) conducted some exploratory research into the level of reserves held by charities. There is clearly an informal point at which charities are somehow judged by some philanthropic organizations to have 'too much' to require funding. Charities and auditors commonly viewed such judgements as unreasonable and ill informed. Although there is firstly a need for standardization of financial reports of charities research into their financial structures would help to lead to a better understanding of an appropriate level of investments.

This research has questioned the economic focus of the conceptual framework and suggested that its boundaries should be defined. Further research into that focus and defining an 'economic event' may help to define those boundaries.

This research has also questioned the appropriateness, as it applies to charities, of a decision usefulness focus that requires users to make an effort to understand financial reports. Research into the intuitive understanding of lay users of financial reports would be applicable to a wider group than merely users of financial reports of charities. In this researcher's experience school boards of trustees demonstrate a similar lack of understanding. If financial reports are to be truly decision useful, some accommodation of lay users is essential.

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Sue Newberry

9 December 1993

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APPENDIX 1

FUND THEORY OF ACCOUNTING

INTRODUCTION

Vatter (1947) produced a doctoral dissertation on *The Fund Theory of Accounting and its Implications for Financial Reports.*

He identified and discussed three meanings of the word "fund".

- an apparent synonym for cash[1];
- a "sinking" fund common at the time in commerce. Vatter defined a sinking fund as involving a separate "income-producing" operation, usually an investment used to retire long-term debt (p11);
- as an extension of the "sinking fund" meaning Vatter defined a fund as "a unit of operations or a center of interest; and, in a completely nonpersonal sense, the fund is the accounting entity. ...In 'fund' accounting a fund is not mere cash resources, and it is more than a mere collection of assets set aside for a particular purpose. The accounts of each fund recognize not only all the asset items but also all the equities that pertain to that fund; in addition, there are also present complete classifications of revenue, expense, and income accounts" (p12).

Having defined funds simply as accounting units (p56) Vatter proposed a number of different funds, drawing parallels between fund accounting and branch accounting. To consolidate the financial reports of various funds he considered the same procedures to be necessary as for any consolidation.

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[1]Vatter criticized the then currently popular statement of funds presented by business organizations. He considered it to be inappropriately named and proposed as a better description of that statement "Summary of Transactions Affecting the Net Working Capital" (p84). He also objected to it "sprout[ing] from the shoulders of some other report" (p84).

Vatter disagreed with cash based accounting and considered that accrual accounting principles, including capitalization of fixed assets and the recognition of depreciation should be applied in fund accounting.

Distinctive Features of Fund Accounting

- residual equity consists only of accumulated surpluses or deficits. This residual equity would be restricted to the purposes of the particular fund;
- equities are defined as restrictions on assets (and would include "investments by owners");
- the income statement would be replaced with a statement of operations which would show all inflows and outflows of resources for the fund. Other financial statements were the same as those proposed under normal accrual accounting.

Orientation

Vatter criticized both the proprietary and the entity[2] theories of accounting. He considered that although it may be acceptable to follow the artificialities of either of these theories if they were followed consistently, neither theory was followed consistently[3]. The reason he proposed for this was that neither theory "meets all the needs, fits all the facts, or allows for the exigencies of solving practical problems" (p10).

For this reason Vatter proposed the fund theory as an alternative for all entities, not merely for government and nonprofit organizations:

> The notion of a fund has not been encumbered by personalistic thinking; it is free from those extensions of meaning which frequently creep into a theory based upon personalizations. ... There is real advantage to be gained from an approach that makes it possible to consider the problem of accounting from a fresh point of view - one which facilitates the separation of issues now hopelessly bound together in the personalistic systems of thought exemplified by both proprietary and entity theories. (p 12-13)

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[2]Vatter maintained that the entity theory was being used as a justification for historical cost, citing Gilman (1939) in support.

[3]Vatter cited Gilman (1939) who considered there was a danger of false reasoning if an unconscious shifting of viewpoints occurred.

Vatter also considered the notion of a fund to be in evidence in aspects of accounting practice.

Reporting

Vatter considered reporting to be the distinctive feature of his fund theory. He disagreed with the accountant's preoccupation with the measurement of income. One of the reasons for Vatter's concerns with determination of income related to his view of the level of understanding of many users of financial reports:

> In considering the problems and practices of income reporting, it is worth keeping in mind that the layman's conception of accounting income is not always a technically adequate one. ... The fact that income is frequently confused with cash balances is not the fault of the accountant, but it is a fact that the accountant should guard against in every possible way... (p75-76)
>
> In this, as in other situations of financial accounting, there are two alternatives; one is to 'educate the public', as the Institute Subcommittee on the Income Statement recommends. ... To educate the mass of laymen who have reason to read and use financial statements is nothing short of an Augean task. (p84)

Vatter opposed presentation of an income statement and suggested instead an operating report in which the reader of the statement would be forced to calculate whichever measures were required[4].

> The operating report should show all the detail that is now considered good practice and more; the point to be made is that there is no reason why the statement has to be arranged in such a way as to emphasize or even calculate an annual net income figure. (p36)

The fund theory operating report would show the change in residual equity, but it would do so by showing the total inflows and outflows of resources for the fund.

Definitions

Vatter proposed an asset/liability view of accounting maintaining views assuming "costs attach" were unnecessary (p17).

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[4]This was criticized as inconsistent by Moyer (1948) and by Zeff (1961) on the basis that a general purpose profit figure would be preferable to none at all.

He offered definitions for elements of financial reports:

- assets: service potentials[5];
- equities: "restrictions that apply to assets[6] in the fund, which therefore condition the operation of the fund" (p19);
- residual equity: "a final pervasive restriction upon fund assets or any residual thereof, in the sense that the entire asset fund is confined to the set of operations for which the fund is established" (p20);
- expenses: applying to a time period. "The only feasible working concept of expense is a flow through time of services released to eventual ends from the fund of assets under consideration" (p24); and
- revenue: "differs from other asset-increasing transactions in that the new assets are completely free of equity restrictions other than the residual equity of the fund itself" (p25). He proposed two criteria for recognizing revenue: whether or not there are new assets (realization); and whether or not the restrictions in the sale contract have been satisfied.

Other Aspects

Vatter described his work as speculative and one of his proposals was to incorporate the double-account style balance sheet, then used by some major English organizations such as railway companies. He illustrated his proposals with an adapted set of financial reports for a manufacturing concern, presenting these financial reports analyzed into five funds. This aspect of Vatter's work was criticized by Moyer (1948) as uncovering "new accounting pitfalls at least, if not more, dangerous than the ones from which we seek release with current practices".

Both Moyer (1948) and Zeff (1961) considered that Vatter's proposals for more financial reports (for each fund) and for users to make their own calculations were

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[5]He considered assets to be central to fund theory and defined a fund at this point as "a collection of service potentials that have been brought together for some functional purpose - administrative, entrepreneurial or social" (p18).

[6]Vatter's view was that a creditor's rights do not relate to specific assets but to the owner or manager of a business. Further, he considered the difference between proprietorship and liability equities to be tenuous at times and the real significance to be "found in the restrictions they impose upon the asset fund, not the quasi-legal or equitable considerations that may be involved" (p20).

unlikely to improve the layperson's understanding of financial reports. They considered them more likely to cause confusion. They did, however, acknowledge the concerns and criticisms Vatter raised about financial reporting.

APPENDIX 2

BALL'S CRITERIA FOR CONTROL

Excerpt from Ball (1988) p 59-60:

The following set of criteria then, while reflective of the major characteristics of a control relationship and while appropriate for the public and private non-corporate sectors, is not intended to be exhaustive:

(i) Financial interdependence

While financial interdependence may take many forms, principal aspects are:

- provision of all, or a significant proportion of, capital or recurrent funds by the reporting entity to the potential subentity;

- power of the reporting entity to approve or not approve significant items of expenditure by the potential subentity. This may be evidenced by power to approve the budget of the potential subentity or power to approve significant projects of a capital nature;

- power of the reporting entity to determine the pricing policy of the potential subentity;

- reponsibility for deficits or surpluses accepted by the reporting entity;

- responsibility for long-term debt to third parties accepted by the reporting entity;

- ownership of assets (e.g., where capital assets used by the potential subentity are owned by the reporting entity);

- power to set financial targets.

(ii) Selection, appointment and removal of management, including the governing body.

Where the reporting entity has selection, appointment and removal powers over senior managerial positions within the potential subentity, there is evidence of control. This does not imply that all management positions within the potential subentity are determined by the reporting entity - for example, the power to appoint a majority of senior management positions of a statutory authority may be sufficient evidence of control. This extends Sec. 7(1)(a)(i) of the Companies Code (1981), recognising that additional evidence of control exists if the reporting entity has selection and appointment powers beyond the Board (where that exists). Similarly, Wettenhall (1983) notes that the tenure of managers or other officers of public sector entities would reflect the influence of (in that case) the Minister.

(iii) Power to direct operations

The power to direct operations may manifest itself in a number of ways. However, there is clear evidence of control, where, for example, the reporting entity has the power to determine:

- the precise nature of services provided;
- the group receiving the service;
- conditions under which a service is provided to recipients;
- the mix of services provided.

In many instances, in the Australian context, Ministers may have limited or unspecified powers to direct statutory authorities or other bodies to act in a certain fashion, and a dominant reporting entity may have similar powers in respect of particular partnerships or other profit and not-for-profit organisations in the private sector.

Criteria (i) and (iii) parallel the position reflected in Exposure Draft 40 (AARF, 1987). Recognition of this relationship serves to emphasise that the criteria should be viewed as a set, in that control is assessed after considering all the elements. While certain of the factors (e.g. provision of all financial resources) would be strong prima facie evidence of control, it would still be necessary to consider the other criteria. It should also be noted that the criteria are not mutually exclusive, for example, the power of the reporting entity to determine the capital budget of a potential subentity (demonstrating financial interdependence) will also give it power to influence the scale and nature of operations.

APPENDIX 3

SAMPLE PROPOSED STATEMENTS OF ACTIVITIES

UNITED STATES

Statement of Activities (FASB, 1993, SFAS117)

Three formats of statements of activities are presented. Each format has certain advantages. Format A reports information in a single column. That format most easily accommodates presentation of multiyear comparative information. Format B reports the same information in columnar format with a column for each class of net assets and adds an optional total column. That format makes evident that the effects of expirations on donor restrictions result in reclassifications between classes of net assets. It also accommodates presentation of aggregated information about contributions and investment income for the entity as a whole. Format C reports information in two statements with summary amounts from a statement of revenues, expenses, and other changes in unrestricted net assets (Part 1 of 2) articulating with a statement of changes in net assets (Part 2 of 2). Alternative formats for the statement of changes in net assets–a single column and a multicolumn–are illustrated. The two statement approach of Format C focuses attention on changes in unrestricted net assets. That format may be preferred by organisations that view their *operating* activities as excluding receipts of donor–restricted revenues and gains from contributions and investment income. To facilitate comparison of the formats, the same level of aggregation is used in each of the statements of activities (FASB, 1993, SFAS117 para 157).

Format A

Not–for–Profit Organization
Statement of Activities
Year Ended June 30, 19X1
(in thousands)

Changes in unrestricted net assets:	
Revenues and gains:	
Contributions	$ 8,640
Fees	5,400
Income on long–term investments (Note E)	5,600
Other investment income (Note E)	850
Net unrealised and realised gains on long–term investments (Note E)	8,228
Other	150
Total unrestricted revenues and gains	28,868
Net assets released from restrictions (Note D):	
Satisfaction of program restrictions	11,990
Satisfaction of equipment acquisition restrictions	1,500
Expiration of time restrictions	1,250
Total net assets released from restrictions	14,740
Total unrestricted revenues, gains, and other support	43,608
Expenses and losses:	
Program A	13,100
Program B	8,540
Program C	5,760
Management and general	2,420
Fund raising	2,150
Total expenses (Note F)	31,970
Fire loss	80
Total expenses and losses	32,050
Increase in unrestricted net assets	11,558
Changes in temporarily restricted net assets:	
Contributions	8,110
Income on long–term investments (Note E)	2,580
Net unrealised and realised gains on long–term investments (Note E)	2,952
Actuarial loss on annuity obligations	(30)
Net assets released from restrictions (Note D)	(14,740)
Decrease in temporarily restricted net assets	(1,128)
Changes in permanently restricted net assets:	
Contributions	280
Income on long–term investments (Note E)	120
Net unrealised and realised gains on long–term investments (Note E)	4,620
Increase in permanently restricted net assets	5,020
Increase in net assets	15,450
Net assets at beginning of year	266,140
Net assets at end of year	$281,590

Format B

Not–for–Profit Organization
Statement of Activities
Year Ended June 30, 19X1
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support:				
Contributions	$ 8,640	$ 8,110	$ 280	$17,030
Fees	5,400			5,400
Income on long–term investments (Note E)	5,600	2,580	120	8,300
Other investment income (Note E)	850			850
Net unrealised and realised gains on long–term investments (Note E)	8,228	2,952	4,620	15,800
Other	150			150
Net assets released from restrictions (Note D):				
Satisfaction of program restrictions	11,990	(11,990)		
Satisfaction of equipment acquisition restrictions	1,500			
		(1,500)		
Expiration of time restrictions	1,250	(1,250)		
Total revenues, gains, and other support	43,608	(1,098)	5,020	47,530
Expenses and losses:				
Program A	13,100			13,100
Program B	8,540			8,540
Program C	5,760			5,760
Management and general	2,420			2,420
Fund raising	2,150			2,150
Total expenses (Note F)	31,970			31,970
Fire loss	80			80
Actuarial loss on annuity obligations		30		30
Total expenses and losses	32,050	30		32,080
Change in net assets	11,558	(1,128)	5,020	15,450
Net assets at beginning of year	103,670	25,470	137,000	266,140
Net assets at end of year	$ 115,228	$ 24,342	$ 142,020	$281,590

Format C, Part 1 of 2

Not–for–Profit Organization
Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets
Year Ended June 30, 19X1
(in thousands)

Unrestricted revenues and gains:	
Contributions	$8,640
Fees	5,400
Income on long–term investments (Note E)	5,600
Other investment income (Note E)	850
Net unrealised and realised gains on long–term investments (Note E)	8,228
Other	150
Total unrestricted revenues and gains	28,868
Net assets released from restrictions (Note D):	
Satisfaction of program restrictions	11,990
Satisfaction of equipment acquisition restrictions	1,500
Expiration of time restrictions	1,250
Total net assets released from restrictions	14,740
Total unrestricted revenues, gains, and other support	43,608
Expenses and losses:	
Program A	13,100
Program B	8,540
Program C	5,760
Management and general	2,420
Fund raising	2,150
Total expenses (Note F)	31,970
Fire loss	80
Total unrestricted expenses and losses	32,050
Increase in unrestricted net assets	$11,558

Format C, Part 2 of 2

Not–for–Profit Organization
Statement of Changes in Net Assets
Year Ended June 30, 19X1
(in thousands)

Unrestricted net assets:	
Total unrestricted revenues and gains	$28,868
Net assets released from restrictions (Note D)	14,740
Total unrestricted expenses and losses	(32,050)
Increase in unrestricted net assets	11,558
Temporarily restricted assets:	
Contributions	8,110
Income on long–term investments (Note E)	2,580
Net unrealised and realised gains on long–term investments (Note E)	2,952
Actuarial loss on annuity obligations	(30)
Net assets released from restrictions (Note D)	(14,740)
Decrease in temporarily restricted net assets	(1,128)
Permanently restricted net assets:	
Contributions	280
Income on long–term investments (Note E)	120
Net unrealised and realised gains on long–term investments (Note E)	4,620
Increase in permanently restricted net assets	5,020
Increase in net assets	15,450
Net assets at beginning of year	266,140
Net assets at end of year	$281,590

Format C, Part 2 of 2 (Alternate)

Not–for–Profit Organization
Statement of Changes in Net Assets
Year Ended June 30, 19X1
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support:				
Unrestricted revenues, gains, and other support	$ 28,868			$28,868
Restricted revenues, gains, and other support:				
Contributions		$ 8,110	$ 280	8,390
Income on long–term investments (Note E)		2,580	120	2,700
Net unrealised and realised gains on long–term investments (Note E)		2,952	4,620	7,572
Net assets released from restrictions (Note D)	14,740	(14,740)		
Total revenues, gains, and other support	43,608	(1,098)	5,020	47,530
Expenses and losses:				
Unrestricted expenses & losses	32,050			32,050
losses: Actuarial loss on annuity obligations		30		30
Total expenses and losses	32,050	30		32,080
Change in net assets	11,558	(1,128)	5,020	15,450
Net assets at beginning of year	103,670	25,470	137,000	266,140
Net assets at end of year	$115,228	$24,342	$142,020	$281,590

UNITED KINGDOM

SORP2 (Charity Accounting Review Committee, 1993)

Consolidated statement of financial activities for the year ended 31 March 1993

	Notes	Unrestricted funds	Restricted funds	Permanent endowment	Totals 31March 1993	Totals 31March 1993
Resources arising		**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Donations and gifts		4,130	3,000	200	7,330	6,000
Legacies		3,500	–	1,000	4,500	1,000
Grants received		–	600	–	600	1,200
Investment income		200	30	20	250	175
		7,830	3,630	1,220	12,680	8,375
Net income of trading subsidiaries	1	220	–	–	220	200
Gross resources arising in year		8,050	3,630	1,220	12,900	8,575
Resources used						
Direct charitable expenditure						
Functional costs		2,100	3,900	–	6000	4,800
Support costs		1,500	1,200	–	2,700	2,400
Publicity		350	150	–	500	600
		3,950	5,250	–	9,200	7,800
Other expenditure						
Fund raising		310	90	–	400	410
Administration		220	–	–	220	190
		530	90	–	620	600
Resources used in year	2	4,480	5,340	–	9,820	8,400
Changes in resources before transfers and valuations		3,570	(1,710)	1,220	3,080	175
Transfers		20	(20)	–	–	–
Realised and unrealised gains and losses						
Unrealised gains on tangible fixed assets		100	–	300	400	100
Realised gains on tangible fixed asset disposals		20	–	–	20	30
Net Investment losses)/gains		(80)	(20)	(110)	(210)	80
Net movement of resources in the year		3,630	(1,750)	1,410	3,290	395
Analysis of net movements in resources for the year						
Net increase/(decrease) intangible fixed assets						
Direct charitable purposes		250	400	300	950	(200)
Other purposes		150	–	–	150	–
		400	400	300	1,100	(200)
Other uses/(utilisation out of balances brought forward)		3,230	(2,150)	1,100	2,190	585
		3,630	(1,750)	1,410	3,290	385

Reconciliation of funds for the year ended 31 March 1993

	Unrestricted £'000	Restricted £'000	Permanent £'000	Total £'000
Balance brought forward 1 April 1992	6,400	3,000	800	10,200
Movements in year				
Net movement of resources in the year	3,630	(1,750)	1,410	3,290
Balance carried forward 31 March 1993	10,030	1,250	2,210	13,490
Represented by				
Tangible fixed assets	4,550	450	500	5,500
Investments	1,000	–	1,000	2,000
Current Assets	6,480	800	710	7,990
Current liabilities	(2,000)	–	–	(2,000)
Total net assets 31 March 1993	10,030	1,250	2,210	13,490
Unrealised gains included above				
On tangible fixed assets	700	–	–	700
On investments	20	–	120	140
Total unrealised gains	720	–	120	840

CANADA

Statement of Operations: Option for those not using Fund Accounting (CICA, 1993)

NPF A
Statement of Operations
for the year ended December 31

	1992	1991
Revenues		
Federal government grants – core operating	$105,000	$100,000
Federal government grants – research	30,000	25,000
General contributions (note 7)	30,000	30,000
Contribution from XYZ Foundation	10,000	20,000
Fees for services	80,000	75,000
Investment income	10,000	15,000
Amortisation of deferred contributions	8,000	7,000
	273,000	272,000
Expenses		
Service delivery – salaries, benefits, and purchased materials and services	223,000	195,000
Research – salaries, benefits and purchased materials and services	32,000	30,000
Amortisation of capital assets	13,000	12,000
	268,000	237,000
Excess of revenues over expenses	$ 5,000	$ 35,000

NPF A
Statement of Changes in Net Assets
for the year ended December 31

Net Assets	Invested in capital assets	Restricted for endowment purposes	Restricted for research purposes	Available	1992 Total	1991 Total
Beginning	$65,000	$100,000	$	$30,000	$195,000	$160,000
Excess (deficiency) of revenues over expenses	(5,000)			10,000	5,000	35,000
Endowment contributions		50,000			50,000	
Internally imposed restrictions		10,000	25,000	(35,000)		
Ending	$60,000	$160,000	$ 25,000	$ 5,000	$250,000	$195,000

Statement of Operations: Fund Accounting Option (CICA, 1993).

NPF A

Statement of Operations and Changes in Fund Balances

for the year ended December 31

	General Fund		Restricted Funds				Endowment Fund	
			Research	Capital Asset	Total	Total		
	1992	1991	1992	1992	1992	1991	1992	1991
Revenues								
Federal government grants	$105,000	$100,000	$30,000	$	$ 30,000	$25,000	$	
Contributions (notes 7 and 8)	40,000	65,000		83,000	83,000		50,000	
Fees for services	80,000	75,000						
Investment income	8,000	5,000	10,000	2,000	12,000	10,000		
	233,000	245,000	40,000	85,000	125,000	35,000	50,000	
Expenses								
Salaries and benefits	200,000	173,000	30,000		30,000	27,000		
Purchased materials and services	23,000	22,000	2,000		2,000	3,000		
Amortisation of capital assets				13,000	13,000	12,000		
	223,000	195,000	32,000	13,000	45,000	42,000		
Excess of revenues over expenses	10,000	50,000	8,000	72,000	80,000	(7,000)	50,000	
Interfund transfers (note 6)	(35,000)		25,000		25,000		10,000	
Fund balances, beginning of year	30,000	(20,000)		135,000	135,000	142,000	100,000	$100,000
Fund balances, end of year	$ 5,000	$30,000	$33,000	$207,000	$240,000	$135,000	$160,000	$100,000